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No. 08-836

IN THE

Supreme Court of the United States

DAVID E. WELCH, CPA, PETITIONER

v.

ELAINE L. CHAO, SECRETARY OF LABOR, UNITED STATES DEPARTMENT OF LABOR, AND CARDINAL BANKSHARES CORPORATION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

DONALD F. MASON, JR.
Counsel of Record

D. BRUCE SHINE

Shine & Mason
433 East Center Street
Suite 201
Kingsport, TN 37660
(423) 246-8433

CURRY & TAYLOR • (202) 393-4141

QUESTIONS PRESENTED

1. Is a CPA who objectively believes that his company's accounting practices produce financial reports which do not meet generally accepted accounting principles and could defraud present and potential shareholders, protected as a whistleblower under the Sarbanes-Oxley Act?

2. Is the Sarbanes-Oxley Act itself a "provision of Federal law relating to fraud against shareholders" which triggers protection under the Act when a whistleblower reports its violation?

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The published opinion of the United States Court of Appeals for the Fourth Circuit in *David E. Welch, CPA v. Elaine L. Chao, Secretary of Labor, United States Department of Labor et al.*, C.A. No. 07-1684, decided August 5, 2008, and reported at 536 F.3d 269(4th Cir. 2008), affirming the decision of the Administrative Review Board that the petitioner was not engaged in protected activity as a whistleblower under the Sarbanes-Oxley Act, is set forth in the Appendix hereto(App. 1-21).

The unreported decision of the Administrative Review Board in *David E. Welch, CPA v. Cardinal Bankshares Corporation*, Docket No. 05-064, dated May 31, 2007, ruling that the petitioner was not engaged in protected activity as a whistleblower under the Sarbanes-Oxley Act, is set forth in the Appendix hereto(App. 22-46).

The unpublished decision of Stephen L. Purcell, Administrative Law Judge, in *David E. Welch, CPA v. Cardinal Bankshares Corporation*, Docket No. 2003-SOX-15, decided January 28, 2004, finding that the petitioner engaged in protected activity as a whistleblower under the Sarbanes-Oxley Act, is set forth in the Appendix hereto(App. 47-203).

The unpublished order of the United States Court of Appeals for the Fourth Circuit in *David E. Welch, CPA v. Elaine L. Chao, Secretary of Labor, United States Department of Labor et al.*, C.A. No. 07-1684, filed on October 3, 2008, denying the petitioner David E. Welch's timely filed petition for rehearing and

for rehearing *en banc*, is set forth in the Appendix hereto(App. 204-205).

JURISDICTION

The decision of the United States Court of Appeals for the Fourth Circuit affirming the decision of the Administrative Review Board that the petitioner was not engaged in protected activity as a whistleblower under the Sarbanes-Oxley Act, was decided August 5, 2008. Its further order denying petitioner's timely filed petition for panel rehearing and for rehearing *en banc* was filed and decided October 3, 2008(App. 1-21;204-205).

This petition for writ of certiorari is filed within ninety (90) days of October 3, 2008. 28 U.S.C. § 2101(c).

The jurisdiction of this Court is invoked pursuant to the provisions of 28 U.S.C. § 1254(1).

RELEVANT PROVISIONS INVOLVED

18 U.S.C. § 1514A(a)(1) & (2) and (b) [Section 806 of the Sarbanes-Oxley Act of 2002]:

> (a) WHISTLEBLOWER PROTECTION FOR EMPLOYEES OF PUBLICLY TRADED COMPANIES.---No company with a class of securities registered under section 12of the Securities Exchange Act of 1934 (15 U.S.C. § 781), or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. § 78o(d)), or any officer, employee contractor, subcontractor, or agent of

such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee—

(1) to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of section[s] 1341, 1343, 1344, or 1348 [of Title 18 of the United States Code], any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by—

(A) a Federal regulatory or law enforcement agency;
(B) any member of Congress or any committee of Congress; or
(C) a person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct); or

(2) to file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation of section[s] 1341, 1343, 1344, or 1348 [of Title 18 of the United States Code], any rule or

regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders.

(b) ENFORCEMENT ACTION.----

(1) IN GENERAL.—A person who alleges discharge or other discrimination by any person in violation of subsection (a) may seek relief under subsection (c), by----

(A) filing a complaint with the Secretary of Labor....

STATEMENT

In the wake of the financial collapse of Enron Corporation and Worldcom Corporation in 2002, congressional investigation revealed employees of these publicly traded companies possessed crucial information about their fraudulent activities. With Enron, an employee whistleblower outlined crucial details about how the company defrauded its shareholders. With Worldcom, testimony revealed that an internal auditor had discovered massive fraud orchestrated by the company's chief financial officer and reported it to the board of directors.

These revelations convinced Congress that to prevent corporate fraud, whistleblowing employees needed incentives to come forward and break the corporate "code of silence." To encourage whistleblowers to disclose corporate financial wrongdoing, protection from retaliation was essential.

When Congress investigated this issue in 2002, it observed that federal and state laws failed to protect whistleblowing employees consistently. Each state had a different level of protection for whistleblowers and measured retaliation differently "although most publicly traded companies do business nationwide." S. Rep. No. 107-146, at 10(2002). Federal law protected only whistleblowers who reported certain types of violations in certain industries. In the face of this federal/state statutory patchwork, employees had difficulty predicting whether they would be protected from retaliation when reporting wrongdoing and this uncertainty discouraged them from coming forward.

To remedy this incomplete statutory patchwork of protection for whistleblowers nationwide, to improve the accuracy and reliability of corporate disclosures made under the securities laws, and to protect innocent investors from corporate fraud, Congress on July 30, 2002, enacted the Sarbanes-Oxley Act of 2002, codified at 15 U.S.C. § 1514A ("SOX" or "the Act"). Employees of companies with publicly traded shares under the Securities Exchange Act of 1934 were thus encouraged to report securities or accounting fraud when and if they perceive it.

The Act contains an anti-retaliation provision to protect whistleblowers from adverse employment actions as long as the conduct reported is wrongdoing which the employee reasonably believes constitutes a violation of 18 U.S.C. §§ 1341(mail fraud), 1343(wire fraud), 1344(bank fraud), or 1348 (securities fraud); any rule or regulation of the Securities and Exchange Commission; or any other provision of Federal law relating to fraud against shareholders. The

whistleblowing employee can provide information to a federal regulatory or law enforcement agency, any member of any committee of Congress, or a person with supervisory authority over the whistleblower..

Employees are protected if they "provide information, cause information to be provided, or otherwise assist in an investigation regarding" such violations. They do not have to report an actual violation of the law; instead, they must only "reasonably believe" that a violation occurred, even if this belief is ultimately shown to be mistaken and an actual violation never occurs. Stated another way, an employee's belief is unreasonable and therefore unprotected if it is based entirely on unsupported conjecture about hypothetical future events. His belief must relate to activity that a reasonable person could conclude is or is about to become a violation. See *Livingston v. Wyeth, Inc.*, 530 F.3rd 344, 361(4th Cir. 2008)(Michael, J., dissenting).

Finally, the Occupational Safety and Health Administration (OSHA), charged with initially investigating whistleblower complaints, can immediately reinstate the whistleblower if it finds reasonable cause to believe that retaliation occurred; and OSHA may also award back pay, special damages including attorney's fees, litigation costs, and expert witness fees.

To gain the protection of SOX, an employee only has to show that he alerted his publicly traded employer, a federal regulatory or law enforcement agency or any member of Congress, to activity which he reasonably believed constituted a violation of an

enumerated law (such as wire or mail fraud) or of a rule or other provision of federal law relating to fraud against a company's investors.

With this statutory law as background, the facts adduced below show that petitioner David E. Welch, CPA ("the petitioner" or "Welch") was a certified public accountant since 1993 and a licensed CPA in Virginia(App. 50). From June, 1997 until August, 1998, he was a Controller for a physicians' group. From September,1998 through February, 1999, he worked as a staff accountant for Larrowe & Company, a CPA firm in Galax, Virginia, where he was responsible for bank audits and other accounting matters, including preparing tax returns for corporations and individuals(App. 50). Welch also taught accounting and finance at two colleges(App. 50-51).

While at Larrowe, one of its clients (Cardinal Bankshares) offered the petitioner the position of Chief Financial Officer(App. 51). The respondent Cardinal Bankshares together with its subsidiary company Bank of Floyd ("the respondent" or "Cardinal") is a bank holding company and a publicly traded corporation listed on the board of the National Association of Security Dealers ("NASDAQ")(App. 51). It was created to allow Bank of Floyd to take advantage of Cardinal's widely recognized name and to enable the Bank to transfer part of its capital to the holding company to avoid some of Virginia's bank franchise taxes(*Id.*). During this time, Cardinal had about 600 shareholders(*Id.*).

As Cardinal's CFO, petitioner was responsible for monitoring and reviewing journal entries posted to

the general ledger accounts for the bank and the holding company. He maintained all the general ledger accounts and prepared all of the financial statements for the holding company(App. 51-52).

During 2001 and prior to SOX's enactment on July 30, 2002, Welch found evidence suggesting that R. Leon Moore ("Moore"), Cardinal's President/CEO and the chairman of its board of directors, had engaged in insider trading of Cardinal's shares, was improperly overriding the company's internal financial controls, was allowing unauthorized personnel access to the company's general ledger accounts and had improperly treated a $195,000.00loan loss recovery as income with the net effect of improperly inflating Cardinal's income for the third quarter of 2001, misleading present and potential investors(App. 52-56).

Welch reported the incidents of insider trading by Moore to the SEC by e-mail around March 29, 2002(App. 56). After SOX was enacted on July 30, 2002, petitioner continued to voice his disagreement with Moore's conduct in managing Cardinal's financial information, data which Welch reasonably believed Moore was confecting for his (and Cardinal's) benefit and to the detriment of the company's present and potential shareholders(App. 56-57).

On August 2, 2002, petitioner wrote the company's outside auditor that as Cardinal's CFO he could not sign a "representation letter"acknowledging Cardinal's consolidated financial statements were prepared in conformity with generally accepted accounting principles (GAAP) and that there were no violations of laws or regulations(App. 57-58). As he

wrote, entries were being made in Cardinal's general financial ledger without his knowledge or approval. In fact, Moore was listed with the auditor as the CFO of Cardinal instead of Welch, and he (Welch) was frequently bypassed during the auditor's search for financial information(App. 58). Finally, he advised that

> [d]uring the first half of 2002, the media has made us acutely aware of corporate wrongdoings. As a result, this past Tuesday, President Bush signed into law a bill that contains some pretty harsh penalties for accounting practices that could result in financial statements being unfairly presented. As a result, I need a better level of comfort before signing a representation [letter] such as yours.

(App. 58).

Twelve days later, Welch restated these concerns in an e-mail to Moore, Cardinal's CEO, advising him that he (Welch) could not certify Cardinal's financial statements filed with the SEC (SEC Form 10-QSB) for the second quarter of 2002(App. 60-61). As an example of misleading journal entries, the petitioner referred to Moore's approval of an erroneous entry of $195,000 in loan loss recovery as income(App. 60-61). In addition, he noted that in 2002, Moore reversed certain expenses which he had already charged against income in 2001, contradictory accounting which did not meet GAAP and showed that the bank was "'managing' net income which [is] unethical and is now seriously illegal"(App. 61).

On September 13, 2002, petitioner wrote Moore to tell him that because of the company's misstated 2001 income, he would not be able to certify Cardinal's financial statements in SEC Form 10-QSB for the third quarter of 2002(App. 61-62). He advised that the bank's income for the third quarter of 2001 should be restated to properly account for the $195,000 loan recoveries "in order to avoid the unfair presentation of financial statements which could lead a reasonable investor to make a decision they might otherwise not make"(App. 62-63). As he reasoned, these overstatements of income for 2001 "made Cardinal look like it was really performing better than it was" and convinced him as a CPA that these untrue statements may have misled investors resulting in the sudden increase in the bank's stock price between early September and late October of 2001 (App. 65-66).

For these reasons, petitioner made clear that his certification of Cardinal's financial reports would not satisfy § 906 of SOX (18 U.S.C. § 1350), which requires a certification that "(1) the report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of and for the periods covered in the Report"(App. 63).

The petitioner met with the bank's senior personnel, including Moore, on September 20, 2002, to explain SOX's reporting requirements and its relationship to Cardinal's suspect accounting practices(App. 80-81). A dispute over tape recording the meeting led some to leave; Welch continued the

meeting and explained to those present the requirements of SOX and his refusal to certify the company's financial reports without restating the 2001 data regarding the $195,000 in loan loss recoveries(App. 81-86).

Cardinal's counsel scheduled a meeting with the petitioner on September 25, 2002, to investigate his allegations of fraud. He told Welch to bring the tape of the earlier meeting(App. 85-86). The petitioner postponed this meeting until he talked to his attorney(App. 86-88). The bank thereupon suspended the petitioner for refusing to meet with its Audit Committee, even though none of this Committee's members were going to be present at petitioner's scheduled meeting with Cardinal's counsel(App. 95).

On October 1, 2002, Cardinal's Audit Committee determined petitioner's attorney would not be allowed to attend its meeting and because of petitioner's alleged unwillingness to meet with it unless his attorney was present, the Committee terminated him(App.100;133). A board of directors' meeting later that day determined that Welch was unwilling or unable to fulfill his responsibilities as CFO and it unanimously voted to terminate his employment(App. 133).

On December 19, 2002, the petitioner filed a whistleblower complaint with OSHA, U.S. Department of Labor, alleging that Cardinal had terminated his employment as CFO in violation of the anti-retaliation provisions of 18 U.S.C. §1514A(a)(1)(App. 23). OSHA dismissed his complaint on February 4, 2003(App. 48). The petitioner appealed and an Administrative Law Judge (ALJ) conducted a *de novo* evidentiary hearing

on August 25-26, 2003(App. 48-49).

On January 28, 2004, the ALJ issued his recommended decision concluding Cardinal had violated SOX when it terminated the petitioner(App. 47-203).The ALJ found that three of the petitioner's allegations against Cardinal about its accounting practices were based upon his reasonable belief that SOX violations were being committed and that his efforts to bring these matters to light constituted "protected activity" within SOX's anti-retaliation provisions(App. 142-143).

First, the ALJ found that Welch reasonably believed the company's incorrect recording of $195,000 in loan recoveries as income was improper and could mislead potential investors(App. 143-146). As a CPA, Welch followed the Federal Reserve's instructions for quarterly call reports which mandate that such loan recoveries "can never go directly against income"(*Id.*). Indeed, Larrowe, the bank's outside auditor, changed these entries when the petitioner brought it to its attention (App. 143). Since these improper entries overstated income for the third quarter of 2001, it was reasonable for the petitioner as a CPA to believe that this material misstatement of Cardinal's income required restatement before he could certify the company's financial reports(App. 145-146).

Second, the ALJ found petitioner reasonably believed the outside auditor did not communicate with him as Cardinal's CFO regarding financial matters entrusted to him by his job description(App. 150). Instead, the outside auditor regularly communicated with Moore, Cardinal's CEO, concerning financial

reporting and about investigating Welch's complaints(App. 149-152).

Third, the ALJ found that it was reasonable for petitioner, as Cardinal's CFO, to believe that it maintained inadequate internal controls over its financial information because too many individuals outside of Cardinal's Finance Department were making entries in the bank's general ledger without his review or knowledge(App. 152-156). As Welch's proof showed, the $195,000 in loan loss recoveries and other sundry credits were entries which overstated the company's income, were made by persons with no accounting experience and were inconsistent with GAAP which requires "that income and expenses be matched against the period in which they are incurred"(App. 154).

The ALJ found that all of these activities were protected by SOX, were known to Cardinal's top management and were contributing factors in the petitioner's suspension and his ultimate termination on October 1, 2002(App. 156-164). As the ALJ found, "[t]he evidence establishes that [Cardinal's] 'investigation' of Welch's complaints was orchestrated by Leon Moore, acting in concert with [the outside auditor] and [the bank's counsel], in such a way that [the bank] could justify [Welch's] termination"(App.157-158). Moreover, Cardinal had not adduced clear and convincing evidence that it would have discharged the petitioner irrespective of his having engaged in this protected activity(App.164-165).

As the ALJ concluded, the petitioner

> has demonstrated by a preponderance of the evidence that he was fired by [Cardinal] because he complied with his duty to disclose information governed by [SOX]....[and Cardinal] has...failed to produce sufficient evidence to clearly and convincingly demonstrate that its motive for firing Welch was unrelated to his protected activity.

(App.173). As relief, the ALJ ordered Cardinal to reinstate Welch and pay him back pay with interest, special damages, attorney fees and expenses(App. 173-176).

Cardinal appealed this decision to the Administrative Review Board(ARB)(App. 23). The ARB ruled that regardless of how Cardinal classified the $195,000 on its books, it was money recovered which it previously did not have(App. 37). It therefore ruled "that an experienced CPA/CFO like Welch could not have reasonably believed that the third quarter SEC report presented potential investors with a misleading picture of Cardinal's financial condition"(App.33-38). The ALJ's finding to the contrary was thus legal error(App. 37).

Welch further argued that Cardinal's misleading financial reports failed to meet GAAP and generally accepted accounting standards (GAAS), that these shortcomings constitute violations of SOX itself since SOX's provisions protect whistleblowers who report a violation of "any... provision of Federal law relating to fraud against shareholders," and that financial reports

which do not meet GAAS and GAAP are presumptively fraudulent and misleading (App. 37-38). The ARB rejected this argument as a wholesale rewriting of SOX because it concluded that Congress could not have intended "to extend protection to those employees who report violations of GAAS, GAAP or FFIEC [Federal Financial Institutions Examinations Council] standards"(App. 38).

Nor did the ARB think Welch's asserted lack of access to the company's outside auditor or his asserted lack of internal controls could have led to his reasonable belief Cardinal was violating any federal law relating to fraud against shareholders(App. 38-42). It therefore reversed the ALJ's decision in favor of petitioner because he had not demonstrated that he had engaged in activity protected under SOX(App. 42).

Welch appealed the ARB's decision to the court of appeals for the Fourth Circuit(App. 1-21). As he had done before the ARB, the petitioner argued that prior to SOX's enactment, the Securities Exchange Act of 1934 together with its regulations and rules imposed GAAS and GAAP upon the financial reports required to be filed by companies whose shares are publicly traded. When Congress enacted SOX in 2002, it further provided that financial reports adjusted for accuracy by accounting firms comply with GAAP. See 15 U.S.C. § 74(i). Thus when the petitioner apprehended that Cardinal had incorrectly credited the $195,000 as income for 2001, as a CPA who had performed numerous bank audits, he had a reasonable belief that this inaccurate entry did not comply with GAAS and GAAP, violating the above mentioned securities laws as well as SOX itself, preventing him from signing

Cardinal's SEC Form10-QSB for the third quarter of 2001.

The court of appeals affirmed the ARB's decision, ruling that petitioner failed to explain to the ARB (or to it) how he could reasonably regard Cardinal's conduct as violating any of the laws listed in SOX(App. 16-17;20-21). In reaching this result, the court rejected Welch's argument that GAAS and GAAP were some of the provisions of Federal law relating to fraud against shareholders which SOX referenced in its own provisions and which should have been enforced here(*Id.*).

On October 3, 2008, the court of appeals denied the petitioner's timely filed petition for panel rehearing or for rehearing *en banc*(App. 204-205).

REASONS FOR GRANTING THE PETITION

The Decision Below Nullifies The Sarbanes-Oxley Act By Failing To Provide Whistleblowers With The Expanded Protection Which Congress Intended.

Upon its enactment in 2002, SOX mandated that corporate accounting protocol adhere to GAAP and GAAS and this requirement became part of the fabric of securities laws and regulations aimed at preventing investor fraud with publicly traded companies. *SOX itself* thus became one of those "provision[s] of Federal law relating to fraud against shareholders" which triggers whistleblower protection under Section 806 of SOX when an employee reports its violation.

Accordingly, when petitioner apprehended that Cardinal had incorrectly credited $195,000 as income for 2001 and was improperly overriding the company's internal financial controls to allow unauthorized personnel access to the company's general ledger accounts, he as a CPA who had performed numerous bank audits had an objectively reasonable belief that this inaccurate entry of financial information did not comply with GAAS and GAAP and violated the securities laws *as well as SOX itself.* He was therefore right as the bank's CFO to refuse to sign Cardinal's SEC Form10-QSB for the third quarter of 2001 and to report these improprieties to his authorities in the bank. Because petitioner was engaging in protected activity under Section 806 of SOX, he was entitled to the whistleblower protection it provided when he was ultimately terminated because of his actions.

Petitioner made this precise argument before both the court of appeals and the ARB. Yet both tribunals failed to appreciate that when SOX was enacted in 2002, it built upon the stringent reporting requirements of the Securities Exchange Act of 1934 together with its regulations and rules which imposed GAAS and GAAP upon the financial reports required to be filed with the SEC by companies whose shares are publicly traded. With SOX, Congress increased and applied these standards for accuracy and honesty in SEC filings onto corporate accounting practices by criminalizing dishonest, misleading financial reporting which defrauds a company's shareholders. *SOX's own reporting requirements—including GAAS and GAAP---are now part of the "provision[s] of Federal law relating to fraud against shareholders" within Section 806 of SOX which triggers its whistleblower protection*

when an employee reports their violation.

Neither the court of appeals nor the ARB grasped this logical, fundamental fact about SOX. The ARB rejected petitioner's argument as a wholesale rewriting of SOX because it concluded that Congress could not have intended "to extend protection to those employees who report violations of GAAS, GAAP or FFIEC [Federal Financial Institutions Examinations Council] standards"(App. 38). The court of appeals affirmed the ARB's disposition holding that petitioner failed to explain to it or to the ARB how he could reasonably regard Cardinal's conduct as violating any of the laws listed in SOX(App. 16-17;20-21)

The failure by the court of appeals and the ARB to appreciate this logical, fundamental fact about SOX, i.e., that a reasonably objective belief that SOX's own reporting requirements including GAAS and GAAP were violated is enough to trigger Section 806's whistleblower protection, nullifies SOX's plain language, constricts the dimensions of "protected activity" which invokes Section 806's whistleblower provisions and frustrates Congress' intent that whistleblowers be given more protection from retaliation than previously provided to encourage their coming forward with crucial information which could avoid the collapse of corporations like Enron and Worldcom and the ensuing harm to shareholders.

Prior to SOX's enactment in 2002, the Securities Exchange Act of 1934 together with its rules and regulations imposed GAAS and GAAP upon the financial reports filed by publicly traded companies. Not only was GAAP imbedded in the reporting

requirements set out by §§ 13(a) and (b) of the Securities Exchange Act (15 U.S.C. § 78m) but also rules promulgated pursuant thereto mandate that accurate reporting for banks meant adherence to "GAAP or FFIEC standards." See 17 Fed. Reg. 41,879(June 20, 2002).

In addition, Regulation S-B, 17 C.F.R. § 228.310, Note 1, applicable to Cardinal as a small business, provides that "[f]inancial statements of a small business issuer, its predecessors or any business to which the small business issuer is a successor *shall be prepared in accordance with generally accepted accounting principles in the United States*" (emphasis supplied). Furthermore, SEC's Regulation S-X, 17 C.F.R. § 210.4-01(a)(1)(2001), applicable to larger institutions, provides that financial statements filed with the Commission which are not prepared in accordance with generally accepted accounting principles *will be presumed to be misleading or inaccurate....*" (emphasis supplied).

Congress built upon these requirements when it enacted SOX in July of 2002. Section103 (15 U.S.C. § 7213(a)(2)(A)(II)(bb)) mandates that a company's financial statements be prepared "in accordance with generally accepted accounting principles;"Section 108 (15 U.S.C. § 77s(b)(1)A)(iv)) encourages the adoption of high quality accounting principles which are "appropriate in the public interest and for the protection of investors;" Section 401 (15 U.S.C. § 78m(i)) requires that any "correcting adjustments" to any financial report or statement be made by a registered public accounting firm "in accordance with generally accepted accounting principles and the rules

and regulations of the Commission;" Section 302 (15 U.S.C. § 7241(a)) makes petitioner as CFO responsible for certifying as accurate and based upon adequate internal controls any periodic financial report of the bank; and Section 906 (18 U.S.C. § 1350) makes petitioner responsible for the accuracy of periodic financial reports under the penalties of fine and incarceration.

This Court has consistently held that any effort to construe a statute, including the securities laws, must begin with the language of the statute itself. *Lewis v. United States*, 445 U.S. 55, __(1976). *Ernst & Ernst v. Hochfelder*, 425 U.S. 425 U.S. 185, 197(1976). SOX's unmistakable language imposes upon Cardinal and its CFO the unwavering duty to maintain adequate internal controls within the bank so that it can file its periodic financial reports with accuracy, transparency and adherence to GAAP and GAAS. It is what the above identified provisions of SOX mandate.

In light of these provisions, petitioner rightly perceived as a CPA and the bank's CFO that the bank's internal controls were inadequate and that the $195,000 loan loss recovery had been improperly reported as income for 2001, in violation of GAAP and GAAS and therefore SOX itself. His refusal to certify the bank's financial report for the third quarter of 2001 therefore had a solid basis in fact and he was entitled to Section 806's whistleblower protection when he reported these violations to his authorities.

The touchstone for interpreting SOX is the prevention of investor fraud. As this Court observed in an analogous context, by placing responsibility in

corporate officers to insure the accuracy and truthfulness of corporate filings, investors are protected from misleading information, substituting "a philosophy of full disclosure for the philosophy of *caveat emptor*." *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 171(1994). Moreover, where Congress intends that securities legislation like SOX be aimed principally at preventing shareholder fraud, its provisions should be construed "'not technically and restrictively, but flexibly to effectuate its remedial purposes.'" *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151(1972) quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195(1963). See *National Assn. of Home Builders v. Defenders of Wildlife*, 551 U.S.___,___(2007)(Steven, J., dissenting).

Petitioner's conduct falls within that plain purpose of preventing investor fraud. Having reasonably apprehended a violation of SOX itself by the bank's lack of internal controls and its filing of a quarterly report which did not meet GAAP and GAAS, he engaged in protected activity when he reported these violations and was entitled to the protection afforded by Congress when it enacted Section 806 of SOX. The court of appeals and the ARB were wrong to suppose that this was an unwarranted expansion of SOX or that petitioner had wrongly placed reliance on GAAP and GAAS in explaining his refusal to sign off on the bank's report. *Accord, Smith v. Corning*, 496 F. Supp. 2d 244, 249-250(W.D.N.Y. 2007)(denying motion to dismiss); *Collins v. Beazer Homes USA, Inc.*, 334 F. Supp. 2d 1365, 1377-1388(N.D. Ga. 2004)(summary judgment denied).

The result below not only nullifies SOX's plain language and its remedial purposes but also constricts the "protected activity" cognizable under Section 806 to such an extent as to repeal the statute altogether, frustrating Congress' intent that whistleblowers be given more protection from retaliation than previously provided and that shareholders receive accurate, timely information about the financial health of the companies they own.

The decision warrants this Court's review because it typifies a consistent line of decisions of several ARBs and this court of appeals which have denied whistleblowers relief at every turn. After all, Congress intended to respond *post*-Enron to

> a culture, *supported by law*, that discourage[s] employees from reporting fraudulent behavior not only to the proper authorities...but even internally. This "corporate code of silence" not only hampers investigations, but also creates a climate where ongoing wrongdoing can occur with virtual impunity. The consequence of this corporate code of silence for investors of publicly traded companies, in particular, and for the stock market, in general, are serious and adverse and they must be remedied.

S. Rep. No. 107-145, at 10(2002)(emphasis supplied). Yet the court of appeals has essentially resurrected the same bad law and the same culture of silence which Congress intended to extinguish when it enacted SOX.

Moreover, as a thorough study recently made clear, there is *not one* reported decision where a

whistleblower has been awarded the ultimate remedy of reinstatement to his job as a result of SOX. See Moberly, Richard E., *Unfulfilled Expectations: An Empirical Analysis of Why Sarbanes-Oxley Whistleblowers Rarely Win*, 49 Will. & Mary L. Rev. 65(2007) *passim*. The federal courts and the various ARBs hearing whistleblower complaints have rendered SOX a sham. The Court should take this opportunity to reverse this trend and breath new life into this statutory scheme consistent with Congress' intent so that the lower federal courts and the federal administrative bodies enforce its provisions instead of reward secrecy and malfeasance.

The result below is also troublesome for the signal it sends to the corporate community about responsible, transparent financial reporting in the post-Enron era. It further weakens an already moribund enforcement scheme of the last eight years by punishing whistleblowers and the investors who depend on them for exposing fraud from the inside. The recent irregularities and collapse of under-regulated investment firms on Wall Street as well as at IndyMac Bank are persuasive proof that this kind of decision making, which guts Congress' remedial legislation and leaves investors on their own with few effective remedies, is unprincipled, unsupported by the law and wrong.

CONCLUSION

For all of these reasons identified herein, a writ of certiorari should issue to review the judgment of the United States Court of Appeals for the Fourth Circuit and, ultimately, to vacate and reverse that judgment and enter a new judgment determining that petitioner engaged in protected activity within SOX and is therefore entitled to reinstatement, back pay with interest, special damages, attorney fees and expenses. This matter should be remanded to the Administrative Law Judge and/or the Administrative Review Board for the United States Department of Labor, with instructions that a judgment enter in petitioner's favor as was originally entered in this case. Finally, it is requested that this Court provide petitioner with such other relief as is fair and just in the circumstances of this case.

Respectfully submitted,

Donald F. Mason, Jr.
Counsel of Record
D. Bruce Shine
Shine & Mason
433 East Center Street
Suite 201
Kingsport, TN 37660
(423)246-8433

(any footnotes trail end of each document)

No. 07-1684

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

DAVID E. WELCH, CPA,
Petitioner,
v.
ELAINE L. CHAO, SECRETARY OF LABOR,
UNITED STATES DEPARTMENT OF LABOR,
Respondent,
CARDINAL BANKSHARES CORPORATION,
Intervenor-Respondent.
GOVERNMENT ACCOUNTABILITY PROJECT;
NATIONAL WHISTLEBLOWER CENTER;
TAXPAYERS AGAINST FRAUD,
Amici Supporting Petitioner,
AMERICAN ASSOCIATION OF BANK
DIRECTORS; VIRGINIA ASSOCIATION OF
COMMUNITY BANKS; VIRGINIA BANKERS
ASSOCIATION,
Amici Supporting Respondent,
SECURITIES AND EXCHANGE COMMISSION,
Amicus Curiae.

May 14, 2008, Argued

August 5, 2008, Decided

On Petition for Review of an Order of the United States Department of Labor. (2003-SOX-15).

COUNSEL: ARGUED: David B. Shine, Donald Franklin Mason, Jr., SHINE & MASON, Kingsport, Tennessee, for Petitioner. Barbara Eby Racine,

UNITED STATES DEPARTMENT OF LABOR, Washington, D.C., for Respondent. Joseph Michael Rainsbury, LECLAIR RYAN, PC, Roanoke, Virginia, for Intervenor. ON BRIEF: Gregory F. Jacob, Solicitor of Labor, Steven J. Mandel, Associate Solicitor, Ellen R. Edmond, Counsel for Whistleblower Programs, UNITED STATES DEPARTMENT OF LABOR, Office of the Solicitor, Washington, D.C., for Respondent. Douglas W. Densmore, LECLAIR RYAN, PC, Roanoke, Virginia; Betty Southard Murphy, Marc A. Antonetti, BAKER & HOSTETLER, LLP, Washington, D.C., for Intervenor. Paul Taylor, TAYLOR & ASSOCIATES, Burnsville, Minnesota; Jason M. Zuckerman, THE EMPLOYMENT LAW GROUP, PC, Washington, D.C., for The Government Accountability Project, The National Whistleblower Center, and Taxpayers Against Fraud, Amici Supporting Petitioner. Arthur P. Strickland, Roanoke, Virginia, for American Association of Bank Directors, Amicus Supporting Respondent. A. Peter Brodell, WILLIAMS MULLEN, PC, Richmond, Virginia; Joseph E. Spruill, III, VIRGINIA BANKERS ASSOCIATION, Glen Allen, Virginia, for Virginia Bankers Association and Virginia Association of Community Banks, Amici Supporting Respondent. Brian G. Cartwright, General Counsel, Andrew N. Vollmer, Deputy General Counsel, Jacob H. Stillman, Solicitor, Mark Pennington, Assistant General Counsel, SECURITIES AND EXCHANGE COMMISSION, Washington, D.C., for Securities and Exchange Commission, Amicus Curiae.

JUDGES: Before MOTZ, Circuit Judge, HAMILTON, Senior Circuit Judge, and Claude M. HILTON, Senior United States District Judge for the Eastern District of

Virginia, sitting by designation. Judge Motz wrote the opinion, in which Senior Judge Hamilton and Senior Judge Hilton joined.

OPINION

DIANA GRIBBON MOTZ, Circuit Judge:

David E. Welch appeals a final order of the Administrative Review Board (ARB) finding that his discharge by Cardinal Bankshares Corporation did not violate the whistleblower protection provision of the Sarbanes-Oxley Act. For the reasons set forth within, we affirm.

I.

Cardinal Bankshares Corporation is a bank holding company with its common stock listed on the NASDAQ Bulletin Board. As of December 31, 2001, Cardinal had outstanding over 1.5 million shares of common stock, held by approximately 600 stockholders of record. Cardinal is the sole owner of a single financial institution, the Bank of Floyd. Cardinal and the Bank of Floyd share a Board of Directors and managing officers, and Ronald Leon Moore serves as the Chief Executive Officer of both entities. Hereinafter, we refer to the Bank of Floyd and Cardinal interchangeably as "Cardinal."

Welch, the petitioner in this case, is licensed as a certified public accountant in Virginia and holds a bachelor's and a master's degree in business administration. Welch began working for Cardinal in 1999 as a part-time accounting officer, and, in 2000,

Moore hired Welch as Cardinal's Chief Financial Officer (CFO). Welch's responsibilities as CFO of Cardinal included preparing and reviewing entries on Cardinal's general ledger accounts; devising and implementing accounting procedures; and preparing various reports and financial statements, including the 10-QSB quarterly reports and 10-K annual reports that Cardinal is required to submit to the Securities and Exchange Commission (SEC), *see* 15 U.S.C. §§ 78l-78m (2000).

Welch came to believe that Cardinal's accounting practices were seriously deficient in several respects. According to Welch, Moore and others who lacked accounting expertise routinely made entries in Cardinal's general ledger; Welch asserts that this practice itself violated generally accepted accounting principles (GAAP). He also contends that this practice resulted in ledger entries that violated GAAP.

Most notably, on one specific occasion, Cardinal recovered two loans that it had previously written off, expecting that they would not be recouped. Cardinal recorded the unexpected recovery of these written-off loans, totaling $ 195,000, as income; Welch maintains that GAAP does not permit such recovered loans to be reported as income and instead requires that they be listed on a company's loan reserve account. Welch attempted to change the ledger entries so that the loans would be recorded in the loan reserve account instead of as income, but Moore refused to authorize these changes. According to Welch, these incorrect entries caused Cardinal to overstate its year-to-date income by $ 195,000 in its 2001 third-quarter 10-QSB report to the SEC. Larrowe & Co., PLC, Cardinal's independent

auditor, eventually corrected these entries in Cardinal's annual report during the 2001 year-end audit, but neither Cardinal nor Larrowe & Co. ever submitted a corrected third-quarter 10-QSB report to the SEC.

Finally, Welch claims that Moore would often communicate directly with Larrowe & Co. about financial matters without including Welch. Welch alleges that by so excluding him, Moore restricted his access to Larrowe & Co., and that this "restricted access" prevented him from performing his tasks as CFO and prevented him from confirming the accuracy of Cardinal's financial reports.

Welch forcefully communicated his concerns about these assertedly improper accounting practices in multiple formal memoranda to Moore and others immediately following the July 30, 2002, effective date of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745. Welch also contends that he raised these concerns orally with Moore and others as they arose in 2001.[1]

On August 2, 2002, Welch informed Larrowe & Co. in writing that he could not sign a representation letter to Larrowe & Co. confirming that Cardinal provided Larrowe & Co. with accurate financial information for the first and second quarters of 2002, because Moore and others had made ledger entries without his supervision and because Moore and Larrowe & Co. had excluded him from their "communications loop" on various issues.

On August 14, 2002, Welch refused to certify Cardinal's 2002 second-quarter 10-QSB report to the SEC, as

required by the Sarbanes-Oxley Act. In a memorandum explaining his refusal to certify the quarterly report, Welch claimed that he could not certify to the accuracy of the company's financial reports because, among other concerns, unauthorized persons had recorded ledger entries. Welch identified the entry as income of the $ 195,000 in recovered loans as evidence of the inaccuracies he believed this practice had caused. Moore ultimately certified Cardinal's quarterly report himself, because Welch refused to do so.

On September 13, 2002, Welch submitted another formal memorandum to Moore, insisting that Cardinal needed to change its accounting practices before Welch could certify the pending 2002 third-quarter 10-QSB report to the SEC. Welch again complained about the entry of the $ 195,000 in recovered loans as income, this time arguing that Cardinal needed to correct its 2001 third-quarter 10-QSB report that listed the $ 195,000 as income; Welch also repeated his complaints that Moore had excluded him from communications with Larrowe & Co. and that unauthorized persons had made ledger entries.

Following this barrage of criticism, Welch's relationship with Moore deteriorated rapidly. On September 17, 2002, Moore called a meeting of Cardinal's Board of Directors to discuss Moore's dissatisfaction with Welch. Moore related to the Board the content of Welch's memoranda and his belief that Welch's concerns were unfounded. Moore also reported that in August 2002, state examiners had found numerous errors in a quarterly call report that Welch had prepared and submitted to the Federal Reserve and the Virginia State Corporation Commission. In addition, Moore

related that the examiners had commented that many of the "charts, graphs, and spreadsheet reports" prepared by Welch were "unnecessary and time-consuming." Moore advised the Board that "the situation has deteriorated to the point that Mr. Welch seems to have become disaffected and apparently is unwilling or unable to do what needs to be done to comply with the law." The Board decided to ask the Audit Committee's legal counsel, Douglas Densmore, and outside auditor, Michael Larrowe, to investigate and prepare a report on Welch's assertions, including his claim that Cardinal needed to correct its third-quarter 2001 SEC report because Cardinal had improperly reported the $ 195,000 in recovered loans as income.

On September 20, 2002, Welch held what he characterized as a "Sarbanes-Oxley briefing" for senior personnel at Cardinal. During this briefing, Welch alleged that three Cardinal employees were "parties to fraudulent acts," outlined his belief that Cardinal's accounting practices violated the Sarbanes-Oxley Act, and proposed that he leave Cardinal quietly upon receipt of a generous severance package. Following the meeting, Densmore and Larrowe attempted to meet with Welch to discuss his charges, but Welch repeatedly refused to meet with them without his personal attorney.

At a meeting of Cardinal's Board of Directors on September 25, 2002, the Board voted to suspend Welch without pay pending the results of Densmore and Larrowe's investigation. Following his suspension, the Board ordered Welch to meet with Densmore and

Larrowe without counsel to discuss his accusations, but Welch again refused to meet without his attorney.

On October 1, 2002, Densmore and Larrowe presented the results of their investigation to the Board. They concluded that Welch's concerns regarding Cardinal's accounting practices lacked merit. They also concluded that Welch had seriously breached his fiduciary duty to Cardinal by refusing to meet with them to discuss his charges, and they recommended that Cardinal discharge him. The Board unanimously voted to discharge Welch, effective immediately.

Welch then filed a complaint with the Occupational Safety and Health Administration (OSHA), alleging that Cardinal had dismissed him in violation of the whistleblower protection provision of § 806 of the Sarbanes-Oxley Act, 18 U.S.C. § 1514A (Supp. V 2005). Welch alleged that his various communications to Cardinal constituted protected activity under the Sarbanes-Oxley Act and that Cardinal fired him because of this protected activity. Based on an investigation by OSHA, the Secretary of Labor dismissed the complaint, finding that, although Welch engaged in protected activity, Cardinal did not fire him because of that activity. Rather, the Secretary found that Cardinal fired Welch because Welch refused to meet with Densmore and Lar-rowe without counsel, which the Secretary concluded constituted a legitimate reason for Welch's discharge.

Welch appealed and requested a hearing before an administrative law judge (ALJ). *See* 29 C.F.R. § 1980.106 (2007). Following the hearing, the ALJ issued a recommended decision and order, finding that at least

three of the concerns that Welch communicated to Cardinal constituted protected activity under the Sarbanes-Oxley Act. Specifically, the ALJ found that the Sarbanes-Oxley Act protected Welch's communications about: (1) Cardinal's entry of the $ 195,000 in recovered loans as income; (2) Cardinal's general practice of allowing persons without accounting expertise to make ledger entries; and (3) Welch's "restricted access" to Larrowe & Co. The ALJ found that Cardinal fired Welch because of these protected activities and ordered him reinstated with back pay. The ALJ later issued a supplemental recommended decision and order, stipulating the amount of back pay to which the judge found Welch entitled.

Cardinal appealed the ALJ's order to the ARB, which reversed, finding as a matter of law that none of Welch's communications constituted protected activity under the Sarbanes-Oxley Act and dismissing Welch's complaint. Welch appeals.

II.

The Sarbanes-Oxley Act creates "whistleblower" protection for employees of publicly-traded companies by prohibiting employers from retaliating against employees because they provided information about potentially unlawful conduct. Specifically, the Sarbanes-Oxley Act provides:

> No [publicly-traded company], or any officer [or] employee . . . of such company, may discharge . . . an employee . . . because of any lawful act done by the employee –

> (1) to provide information . . . regarding any conduct which the employee reasonably believes constitutes a violation of section 1341 [mail fraud], 1343 [wire fraud], 1344 [bank fraud], or 1348 [securities fraud], any rule or regulation of the [SEC], or any provision of Federal law relating to fraud against shareholders, when the information . . . is provided to . . .
>
> . . . a person with supervisory authority over the employee . . . .

18 U.S.C. § 1514A(a); *see also Livingston v. Wyeth, Inc.*, 520 F.3d 344, 351 (4th Cir. 2008); *Allen v. Admin. Review Bd.*, 514 F.3d 468, 475 (5th Cir. 2008).

The whistleblower protection provision of the Sarbanes-Oxley Act adopts the burden-shifting framework applicable to whistleblower claims brought under the Wendell H. Ford Aviation Investment and Reform Act for the 21st Century, 49 U.S.C. § 42121(b) (2000). *See* 18 U.S.C. § 1514A(b). Accordingly, an employee bears the initial burden of making a prima facie showing of retaliatory discrimination; the burden then shifts to the employer to rebut the employee's prima facie case by demonstrating by clear and convincing evidence that the employer would have taken the same personnel action in the absence of the protected activity. 49 U.S.C. § 42121(b)(2)(B).

The Department of Labor (DOL) regulations implementing § 1514A provide that in order to make a prima facie showing, an employee's complaint must allege that: (1) the employee engaged in protected activity; (2) the employer knew, actually or

constructively, of the protected activity; (3) the employee suffered an unfavorable personnel action; and (4) the circumstances raise an inference that the protected activity was a contributing factor in the personnel action. 29 C.F.R. § 1980.104(b)(1) (2007).

To satisfy the first element and establish that he engaged in protected activity, an employee must show that he had both "a subjective belief and an objectively reasonable belief that the conduct he complained of constituted a violation of relevant law. *Livingston*, 520 F.3d at 352. Additionally, an employee must show that his communications to his employer "definitively and specifically relate[d]" to one of the laws listed in § 1514A. *Platone v. FLYi, Inc.*, ARB Case No. 04-154, 2006 DOLSOX LEXIS 105 at *33 (ARB Sept. 29, 2006) (internal quotation marks omitted). The ARB held that Welch failed to make out a prima facie case because he did not establish that he had engaged in protected activity; the ARB did not make any determination as to the other three elements necessary for a prima facie case.

Under the Administrative Procedure Act, 5 U.S.C. § 706(2)(A) (2006) -- which governs our review here, *see* 49 U.S.C. § 42121(b)(4)(A) -- we may only disturb the ARB's decision if it was "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." We review questions of law *de novo*, giving deference to the ARB's interpretation of § 1514A. *See Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843-44, 104 S. Ct. 2778, 81 L. Ed. 2d 694 (1984)[2] On questions of fact, we will uphold the ARB's findings if supported by substantial evidence. *See Knox v. U.S. Dep't of Labor*, 434 F.3d 721, 723-24 (4th Cir. 2006).

III.

Before turning to the central dispute here -- whether the ARB erred in holding that Welch had failed to establish that his communications constituted protected activity under § 1514A -- we briefly address contentions made by the parties as to the standard for establishing protected activity.

Cardinal initially argues that *Livingston* holds that the Sarbanes-Oxley Act only protects communications relating to *material* violations of a listed law. As Cardinal itself concedes, however, in *Livingston*, we merely noted that a statement or omission must concern a material fact to violate § 10(b) of the Securities Exchange Act and SEC Rule 10b-5. 520 F.3d at 355. Although many of the laws listed in § 1514A of the Sarbanes-Oxley Act contain materiality requirements, nothing in § 1514A (nor in *Livingston*) indicates that § 1514A contains an *independent* materiality requirement.[3]

The parties' remaining contentions involve the ARB's interpretation of § 1514A to require that an employee's communications to his employer "definitively and specifically relate" to one of the listed laws for these communications to constitute protected activity. *See, e.g., Platone*, ARB Case No. 04-154, 2006 DOLSOX LEXIS 105 at *34 (internal quotation marks omitted). This requirement ensures that an employee's communications to his employer are factually specific. An employee need not "cite a code section he believes was violated" in his communications to his employer, but the employee's communications must identify the specific conduct that the employee believes to be illegal.

Fraser v. Fiduciary Trust Co. Int'l, 417 F. Supp. 2d 310, 322 (S.D.N.Y. 2006); *see also Bechtel Constr. Co. v. Sec'y of Labor*, 50 F.3d 926, 931 (11th Cir. 1995) (considering standard for protected activity under the whistleblower provisions of the Energy Reorganization Act, 42 U.S.C. § 5851). "[G]eneral inquiries do not constitute protected activity." *Fraser*, 417 F. Supp. 2d at 322 (internal quotation marks, omissions, and citations omitted).

Welch maintains that by requiring his communications to "definitively and specifically relate" to a listed law, the ARB has interpreted § 1514A to require that an employee complain of an *actual* violation of a listed law in order to engage in protected activity, and that such a requirement contradicts the text of the statute, which provides that an employee who complains of conduct that he "reasonably believes" violates a listed law engages in protected activity. 18 U.S.C. § 1514A(a)(1). We agree that such a requirement *would* contradict the text of § 1514A, but the "definitively and specifically" language does *not* in fact require that an employee complain of an *actual* violation. Indeed, the ARB has squarely held that § 1514A protects an employee's communications based on a reasonable, but mistaken, belief that conduct constitutes a securities violation. *See Halloum v. Intel Corp.*, ARB Case No. 04-068, 2006 DOLSOX LEXIS 5, slip op. at 6 (ARB Jan. 31, 2006); *accord Allen*, 514 F.3d at 477.

Cardinal also misreads the "definitively and specifically" language, though in a different manner. Cardinal contends that the "definitively and specifically" language imposes a heightened pleading standard in Sarbanes-Oxley whistleblower cases. The ARB,

however, has held that, for the requirement that an employee's communications "definitively and specifically relate" to a listed law, the "relevant inquiry" is what an employee "actually communicated to [his] employer prior to the . . . termination"; it is "*not* what [is] alleged in [the employee's] OSHA complaint." *Platone*, ARB Case No. 04-154, 2006 DOLSOX LEXIS 105 at *34-35 (emphasis added). Thus, contrary to Cardinal's assertions, the "definitively and specifically" language clearly does not impose a heightened pleading standard in Sarbanes-Oxley whistleblower cases.

Accordingly, we turn to the central issue in this case -- whether Welch established that his communications constituted activity protected by § 1514A.

IV.

The ARB held that Welch had failed to establish that any of his communications constituted protected activity under § 1514A of the Sarbanes-Oxley Act. The ARB offered two rationales for its holding; both relate to the requirement that Welch have an objectively reasonable belief that the challenged conduct violated relevant law. Although we must reject the first rationale, we find no error in the second.

A.

The ARB initially held, as a matter of law, that Welch could not have had an objectively reasonable belief that reporting the $ 195,000 in recovered loans as income violated relevant law.[4] The ARB reasoned that even if Cardinal erroneously reported the $ 195,000 as income instead of recording it in the loan reserve account, the

erroneous entries still showed that "Cardinal had in fact recovered $ 195,000 that it previously did not have," and that therefore Welch could not have had an objectively reasonable belief that the loan entries might mislead investors.

The ARB suggested that the misclassification of items in a financial statement can *never* "present[] potential investors with a misleading picture of [a company's] financial condition," so long as the misclassification does not affect the "bottom line." We disagree. As the SEC has explained in its amicus brief, "'[t]he individual items, subtotals, or other parts of a financial statement may often be more useful than the aggregate to those who make investment, credit, and similar decisions.'" Statement of the SEC, Amicus Curiae, in Support of Neither Side at 3 (quoting the Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 5, Recognition and Measurement of Financial Statements of Business Enterprises 15-16, Par. 22 (Dec. 1984)) (emphasis omitted). Thus, as the Department of Labor now concedes, communications about misclassifications in financial statements *may*, in some circumstances, form the basis for a Sarbanes-Oxley whistleblower action, and the ARB erred to the extent that it held to the contrary. Were this the *only* rationale for the ARB's holding, we would have to remand to allow the ARB to determine whether Welch could have reasonably believed that *this* misclassification violated relevant law.

B.

The ARB offered a second rationale for its dismissal of Welch's complaint, however. The ARB held that even if

Welch's charges proved correct -- that Cardinal reported the $ 195,000 as income in violation of GAAP, that Cardinal improperly restricted Welch's access to Larrowe & Co., and that Moore permitted individuals without expertise to make ledger entries -- Welch had nonetheless failed to explain to the ARB how he could have had an objectively reasonable belief that these actions violated any of the laws listed in § 1514A.

After the ALJ ruled in favor of Welch, Cardinal filed a petition for review with the ARB, taking exception to the ALJ's findings of fact and conclusions of law, pursuant to 29 C.F.R. § 1980.110 (2007). Cardinal specifically took issue with the ALJ's rulings that Welch had an objectively reasonable belief that his communications identified violations of federal securities laws. *See* Resp't's Pet. for Review at Pars. 2, 4, 5 (Feb. 25, 2005). Cardinal argued that:

> The ALJ erred in finding protected activity because Welch's complaints . . . did *not* allege conduct that constituted a violation of, or even a reasonably perceived violation of, federal securities laws. Conspicuously absent from the ALJ's analysis is any explanation of how the conduct Welch complained about constituted a violation of federal securities laws.

Br. of Resp't at 11, Welch v. Cardinal Bankshares Corp., ARB Case No. 05-064 (ARB May 31, 2007). Cardinal stressed that the ALJ had cited "no authority" to support the proposition that the identified conduct violated federal securities laws. *Id.* at 18; *see also id.* at 16 (asserting that Welch's communications "did not allege a violation of federal securities law" and that

"[t]he ALJ fails to point to a single statute, regulation, or case" in support of his holding).

In his response before the ARB, Welch defended the ALJ's holding, but, like the ALJ, he utterly failed to explain how Cardinal's alleged conduct could reasonably be regarded as violating any of the laws listed in § 1514A. Although Welch advanced several arguments before the ARB, he supported these arguments only with irrelevant and inapposite authority or conclusory, general statements.[5] ARB therefore held that Welch had failed to establish that he engaged in protected activity. We find no error in this ruling. *See, e.g., Hall v. U.S. Dep't of Labor, Admin. Review Bd*, 476 F.3d 847, 861 n.8 (10th Cir. 2007) (explaining that the ARB is not required to "*sua sponte* raise legal theories referenced only obliquely by a party but not clearly articulated in its briefs"); *cf.* Fed. R. App. P. 28(b), (a)(9)(A) (requiring the appellee's brief to contain an argument, which must, in turn, include "citations to the authorities and parts of the record on which [that party] relies").

To the extent that Welch *now* explains his position and cites to relevant authority in his filings before this court, he attempts to raise new arguments relying on newly identified authorities. Welch has forfeited these new arguments by failing to raise them before the ARB. *See, e.g., Taylor v. U.S. Dep't of Labor*, 440 F.3d 1, 8-9 (1st Cir. 2005).

Of course, we do not suggest that a whistleblower must identify specific statutory provisions or regulations when complaining of conduct to an employer, nor do we address the burden upon the parties in the proceedings

before the ALJ. See 29 C.F.R. §§ 1980.103-109 (2007). We simply hold that Welch completely failed to raise any relevant arguments before the ARB and may not now raise new arguments before this court.

V.

For the reasons set forth above, the judgment of the Administrative Review Board is

AFFIRMED.

Footnotes

1Additionally, in October 2001, Welch sent a memorandum to Moore advising that he had done "some research on the internet" concerning insider trading and that "[Moore's] personal trades and some of [Moore's] friends' trades" were "questionable." Welch testified that he later filed a complaint with the SEC accusing Moore of insider trading, but the SEC did not take any action on the complaint. Welch does not pursue any asserted insider trading violations on appeal.

2The Supreme Court has recognized that *Chevron* deference is appropriate when it appears from the "statutory circumstances that Congress would expect the agency to be able to speak with the force of law." *United States v. Mead Corp.*, 533 U.S. 218, 229, 121 S. Ct. 2164, 150 L. Ed. 2d 292 (2001). The Court has instructed that "[i]t is fair to assume generally that Congress contemplates administrative action with the effect of law when it provides for a relatively formal administrative procedure" such as formal adjudication.

Id. at 230 & n.12. Congress explicitly delegated to the Secretary of Labor authority to enforce § 1514A by formal adjudication, *see* 18 U.S.C. § 1514A(b), and the Secretary has delegated her enforcement authority to the ARB, *see* 67 Fed. Reg. 64,272, 64,273 (Oct. 17, 2002). Thus, we afford deference to the ARB's interpretation of § 1514A of the Sarbanes-Oxley Act. Welch does not argue to the contrary.

3Relying on dicta in *Livingston*, 520 F.3d at 351 & n.1, Cardinal also contends that § 1514A only protects communications concerning violations of SEC rules or regulations that "relate to fraud" and that the asserted violations raised by Welch do "not relate to fraud." Welch counters that we did not so hold in *Livingston*, and would not so hold now if squarely presented with the question, *see, e.g., O'Mahony v. Accenture Ltd.*, 537 F. Supp. 2d 506, 516-17 (S.D.N.Y. 2008), and that in any event his communications do relate to fraud. We need not resolve this question here, however, because, as discussed below, Welch failed to explain to the ARB how he could have had an objectively reasonable belief that Cardinal violated *any* potentially relevant law, whether or not it related to fraud.

4In order for an employee to prove that he engaged in protected activity, he must show that he possessed both a subjective belief and an objectively reasonable belief that the conduct complained of constituted a violation of relevant law. *Livingston*, 520 F.3d at 352; *Melendez v. Exxon Chems. Ams.*, ARB Case No. 96-051, slip op. at 25-29 (ARB July 14, 2000). Thus, the employee must show both that he actually believed the conduct complained of constituted a violation of pertinent law and that "a reasonable person in his position would have

believed that the conduct constituted a violation." *Livingston*, 520 F.3d at 352; *accord Allen*, 514 F.3d at 477.

Welch argues that the ARB erroneously held that objective reasonableness is *always* a question of law. We agree that the ARB would have erred if it had so held, because objective reasonableness is a mixed question of law and fact. But the ARB did not hold that objective reasonableness is *always* a question of law. Rather, the ARB decided the question of objective reasonableness as a matter of law *in this case*, as we did in *Jordan v. Alternative Resources Corp.*, 458 F.3d 332, 340-41 (4th Cir. 2006). As in *Jordan*, the ARB applied the familiar rule that issues may be decided as a matter of law if the facts cannot support a verdict for the non-moving party. *Accord Livingston*, 520 F.3d at 353-56; *Allen*, 514 F.3d at 477-78.

5For example, before the ARB, to support his contentions regarding the $ 195,000 in recovered loans in the 2001 third-quarter 10-QSB report, Welch relied on laws and regulations passed years *after* the filing of that report, as well as other regulations which clearly do not fall within the purview of § 1514A. He also cited to general accounting standards and the general purpose of the securities laws. He did not explain -- as he attempts to on appeal -- how a person could reasonably believe that the failure to correct the 10-QSB report might violate any relevant federal law or applicable SEC regulation. Similarly, with regard to Cardinal's practice of allowing individuals without accounting expertise to make ledger entries, before the ARB, Welch cited accounting treatises and insisted that the practice "violat[ed] the intent of the SEC rules

and regulations," but he never explained how a person could have an objectively reasonable belief that this conduct violated any of the laws listed in § 1514A.

ARB CASE NO. 05-064
ALJ CASE NO. 2003-SOX-15
DATE: May 31, 2007

In the Matter of:

DAVID WELCH,

COMPLAINANT,

v.

CARDINAL BANKSHARES CORPORATION,

RESPONDENT.

BEFORE: THE ADMINISTRATIVE REVIEW Board

Appearances:

For the Complainant:
D. Bruce Shine, Esq., Donald F. Mason, *Shine & Mason*, Kingsport, Tennessee

For the Respondent:
Laura Effel, Esq., Douglas W. Densmore, Esq., Joseph M. Rainsbury, Esq., *Leclair, Ryan Flippin Densmore*, Roanoke, Virginia; Betty Southard Murphy, Esq., Marc A. Antonetti, Esq., *Baker & Hostetler LLP*, Washington, D.C.

For Amicus Curiae American Ass'n of Bank Directors:
Arthur P. Strickland, Esq., Roanoke, Virginia

For Amici Curiae Virginia Bankers Ass'n and Virginia Ass'n of Community Banks: Joseph E. Spruill, III, Esq., G. Andrew Nea, Jr., *Williams Mullen*, Richmond, Virginia

For Amicus Curiae American Bankers Ass'n: C. Dawn Causey, General Counsel, Gregory F. Taylor, Assoc. General Counsel, Washington, D.C.

FINAL DECISION AND ORDER

David E. Welch filed a complaint with the United States Department of Labor in which he alleged that Cardinal Bankshares Corp. (Cardinal) violated the employee protection provision of the Sarbanes-Oxley Act of 2002 (SOX)[1] when it terminated his employment on October 1, 2002. After a hearing, an Administrative Law Judge (ALJ) concluded that Cardinal had violated the SOX and recommended that Welch be reinstated and receive back pay and other relief. But because the ALJ committed legal error, we will not adopt his recommendation, and we deny Welch's complaint.

BACKGROUND

Cardinal is a publicly-traded bank holding company subject to the SOX's employee protection section. Cardinal, which was established in 1996, is the sole owner of Bank of Floyd and its branch offices located in and near Floyd, Virginia. Cardinal and the bank share office facilities, employees, and executive staff.[2] Transcript (T) 29.

Ronald Leon Moore, who had been working for the bank since 1988, helped create the holding company and

subsequently served as Cardinal's Chief Executive Officer, member and chairman of Cardinal's Board of Directors, and member of the Board's Audit Committee. Moore hired Welch as a part-time accounting officer in February 1999. About a year later, Welch asked for a full-time position as Cardinal's Chief Financial Officer, and Moore agreed. Welch is a certified public accountant and holds a masters degree in business administration. As CFO, Welch's essential duties included preparing federal, state, and local financial reports of various kinds; developing accounting control procedures; and reviewing and correcting "errors and inconsistencies in financial entries, documents, and reports." Complainant's Exhibit (CX) 35; T 245-246, 357.

The financial records and reports Welch produced included quarterly "call reports" to state bank examiners and the Federal Reserve Board and quarterly (Form 10-QSB) and annual (Form 10-K) reports to the Securities and Exchange Commission (SEC). The SEC reports contain financial information such as a statement of operations, income statement, balance sheet, statement of cash flows, and changes in capital based on shares bought and sold, as well as company commentary. A local accounting firm, Larrowe & Co., provided Cardinal with independent audits for the quarterly reports. T 42.

Welch based the reports he produced on Cardinal's "general ledgers," or "journals," where Welch and others recorded all financial transactions. Cardinal required that a witness countersign each ledger entry and that the CFO review all entries every month. Thus, every month Welch reviewed the ledger for errors and either

made corrections himself or recommended corrections to Moore. CX 23.

Welch testified that he believed that Cardinal violated generally accepted accounting practices (GAAP) because Cardinal allowed people with no special accounting skills to make ledger entries. Under GAAP standards, only persons with accounting expertise should be permitted to make ledger entries. In fact, Welch testified that he wanted all but routine entries to be cleared with him in advance. CX 23; T 61. Moore, who often made ledger entries himself or directed others to make entries, would not agree to limit access to the ledger or to turn over ledger entry control to Welch. And on occasion, Moore refused to make corrections Welch thought should be made.

In the second and third quarters of 2001, Moore recorded two loan recoveries as forms of income ($45,000 in June 2001, and $150,000 in July 2001) on accounts Cardinal had previously written off. Consequently, Cardinal's third-quarter 10-QSB report to the SEC included this $195,000 in year-to-date income.[3] Welch discovered the entries during his September ledger review and told Moore that GAAP standards do not permit loan recoveries to be treated as income. Instead, they must be accounted for in the "loan reserve" account.[4] In the last quarter of 2001, Welch told Moore that the misclassification caused Cardinal's third quarter SEC report to overstate Cardinal's year-to-date income. Later, when Larrowe & Co. audited Cardinal's annual SEC report for 2001, Welch pointed out the error to Beth Worrell, the auditor in charge, and she corrected the accounting according to Welch's recommendation. CX 12; CX 23; T 49, 52-55.

Welch had other concerns besides the loan recoveries. Moore repeatedly rejected Welch's accounting advice, and Welch felt excluded from discussions between Moore and Larrowe & Co. about accounting issues. In October 2001, Welch sent Moore a memo in which he formally accused Moore of insider trading. And in March 2002, Welch filed a complaint with the SEC accusing Moore of insider trading. In June 2002, when Cardinal agreed to merge with MountainBank Financial Corporation, Welch feared that his job would be eliminated. Then, in July, Wanda Gardner, Cardinal's internal auditor, reported to the Board of Directors that Welch's system for retrieving wire transfer information was severely flawed. In August, state bank examiners found over a dozen errors in one of Welch's call reports. CX 6; CX 8; CX 24; T 38-30, 57, 110-111, 116. During the state banking review, Welch emailed one of the examiners that he, Welch, had information about "things that have gone on at the bank that I do not think are on the up and up." But neither the SEC nor the state bank examiners showed any interest in Welch's claims. CX 13; CX 14 p. 2; T 137-130, 156. Welch did not take any of these concerns to Cardinal's Board of Directors or its Audit Committee because he was afraid that Moore would fire him for doing so. T 125, 140.

Welch wrote Larrowe & Co.'s Worrell on August 2, 2002, that he would not be signing a "representation letter" she had prepared for his signature. The representation letter was a statement attesting to the accuracy, reliability, and completeness of the financial data that Cardinal was providing to Larrowe & Co. Welch was concerned that unqualified persons were making ledger entries, and he told Worrell that he

could not sign the representation letter because "over the past year to year and a half, I have been excluded from your [Larrowe & Co. and Moore] communications loop almost entirely." CX 17.

Two weeks later, Welch notified Moore by memo about these same concerns and therefore would not certify Cardinal's next 10-QSB report either. CX 20. A month later, Welch followed up with a more detailed memo to Moore, elaborating on his opinion that in its 2001 third-quarter 10-QSB Cardinal had overstated its year-to-date income by $195,000 and should file a corrected report, complained that he was being excluded from the process of designing disclosure controls and procedures as the SOX required, complained that he was not permitted to address the Audit Committee or the Board of Directors, and reiterated his views that people without accounting expertise should not be making ledger entries and that Moore had engaged in insider trading. T 109, 119-120; CX 1.

Moore called a special meeting of the Board on September 17, 2002, in which he read Welch's memo and described various ways that Welch's performance as CFO had been unsatisfactory. Douglas Densmore, counsel to the Board and the Audit Committee, recommended that the Audit Committee investigate Welch's charges and that Cardinal discuss the situation with banking regulators and MountainBank Financial Corp. Venson Bolt, Chairman of the Audit Committee, asked Michael Larrowe and Densmore to investigate Welch's charges and report their findings in writing. Joint Exhibit (JX) 1.

Meanwhile, Welch scheduled a Sarbanes-Oxley "Briefing" for Cardinal managers on September 20 and consulted with an attorney on how best to make his presentation. According to an outline he prepared, Welch planned to tell the attendees that some of Cardinal's accounting practices were illegal, including treating loan recoveries as income, excluding him from Moore's consultations with Larrowe & Co., and allowing persons without accounting expertise to make entries to the general ledger. JX 2; CX 26; Respondent's Exhibit (RX) 1; T 74-81.

He then planned to excuse everyone except Fred Newhouse, the Executive Vice President, and Marie Thomas, head of Human Resources. To Newhouse and Thomas, Welch would present the terms of a retirement package he wanted in exchange for leaving the bank "without saying anything to anyone" about accounting problems at Cardinal. He wanted a salary payment of more than one week for each year of service, the remainder of his 2001 performance bonus, full vesting of his retirement, including all of the Bank of Floyd's contributions, and a letter of recommendation. JX 2; T 144-153; RX 1.

The group convened on the 20th. Welch began by turning on a tape recorder, and when Moore asked him to turn it off, Welch refused. After explaining to the group that he had been consulting with a lawyer, Welch announced, "I tell you there's three people in this room that are parties to fraudulent acts . . . ." At that point, Moore and Battle left the meeting, and Welch continued as planned. JX 2; T 148-152.

The following week, when Densmore and Larrowe tried to interview Welch and to get a copy of the September 20 tape recording, Welch told them he did not have the tape and had not been able to consult with his attorney since the September 20 meeting. JX 6, 8, 9, 10, 11. But he told them that he had an appointment with his attorney on the following day, and would then decide how to proceed. JX 6.

When Densmore and Larrowe reported to Bolt that Welch was not willing to be interviewed because his attorney was out of town, Bolt suspended Welch with pay pending the outcome of the investigation. "We consider your refusal to meet with counsel and outside auditors to discuss matters within your area of responsibility a serious breach of your legal obligations to the company and its Board of Directors." JX 11.

After consulting his lawyer and scheduling a meeting with Densmore and Larrowe for September 30, Welch notified Densmore that he would not meet with him and Larrowe after all and would not meet with the audit committee unless he could bring his attorney. And Welch's attorney, writing to Densmore, stated that "[i]f it is your intent not to allow me to represent Mr. Welch in front of the Committee, please let me know so we can cancel the meeting." JX 18.[5]

The meeting was cancelled, and on October 1, 2002, Densmore and Larrowe presented their findings to members of the Board and the Audit Committee. Densmore and Larrowe concluded that the available information material in Larrowe & Co. files, Welch's memos and letters to Moore, Worrell, and others, and statements from various Cardinal employees did not

support Welch's allegations. Densmore and Larrowe told the Board that if Welch really thought that Cardinal's accounting practices were deficient to the point of illegality, he had a fiduciary duty not only to tell the Board or the Audit Committee, but to cooperate unconditionally in the Committee's efforts to investigate his charges. Densmore and Larrowe recommended that the Board terminate Welch's employment immediately. By unanimous vote, the Board converted Welch's suspension into a termination effective October 1. JX 19, 20, 21, 22.

Welch then filed this whistleblower complaint. After an investigation, the Occupational Safety and Health Administration (OSHA), the Labor Department agency charged with investigating SOX whistleblower complaints, concluded that Welch's complaint had no merit. Welch requested a hearing before a Labor Department ALJ. As already noted, the ALJ concluded that Cardinal violated the SOX and recommended that Welch be reinstated and receive back pay and other forms of relief. Cardinal appealed.

JURISDICTION AND STANDARD OF REVIEW

The Secretary of Labor has delegated her authority to issue final agency decisions under the SOX to the Administrative Review Board.[6] Pursuant to the SOX and its implementing regulations, the Board reviews the ALJ's fact findings under the substantial evidence standard.[7] Substantial evidence is that which is "more than a mere scintilla. It means such relevant evidence as a reasonable mind might accept as adequate to support a conclusion."[8] We must uphold an ALJ's factual finding that is supported by substantial

evidence even if there is also substantial evidence for the other party and even if we "would justifiably have made a different choice had the matter been before us de novo."[9]

In reviewing the ALJ's conclusions of law, the Board, as the Secretary's designee, acts with "all the powers [the Secretary] would have in making the initial decision . . . ."[10] Therefore, the Board reviews an ALJ's conclusions of law de novo.[11]

Discussion

1. The Legal Standard

The employee protection provision of the SOX prohibits employers from retaliating against employees for providing information or assisting in investigations related to securities fraud:

(a) Whistleblower protection for employees of publicly traded companies.--No company with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l), or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)), or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee--

(1) to provide information, cause information to be provided, or otherwise assist in an investigation

regarding any conduct which the employee reasonably believes constitutes a violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by--

(A) a Federal regulatory or law enforcement agency;

(B) any Member of Congress or any committee of Congress; or

(C) a person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct); or

(2) to file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders.[12]

To prevail, Welch must prove by a preponderance of the evidence that: (1) he engaged in a protected activity or conduct; (2) Cardinal knew that he engaged in the protected activity; (3) Welch suffered an unfavorable personnel action; and (4) the protected activity was a contributing factor in the unfavorable action.[13]

With respect to the protected activity requirement, Welch must prove by a preponderance of the evidence

that he provided information to Cardinal that he reasonably believed constituted a violation of 18 U.S.C.A., sections 1341 (mail fraud), 1343 (wire, radio, TV fraud), 1344 (bank fraud), or 1348 (securities fraud), or any rule or regulation of the Securities and Exchange Commission (SEC), or any provision of Federal law relating to fraud against shareholders.[14] Under the SOX, the employee's communications must "definitively and specifically" relate to any of the listed federal securities laws.[15]

Welch claimed that he engaged in five protected activities. The ALJ concluded that Welch engaged in three and made no findings as to the other two. Recommended Decision and Order (R. D. & O.) at 53-54. Welch has not objected so we limit our decision to the three activities that the ALJ addressed.

2. Welch Did Not Engage in SOX-Protected Activity

A. The $195,000 Loan Recovery Entries

The ALJ found that in September 2001 Welch told Moore that the loan recoveries should not be classified as income. He concluded that Welch reasonably believed that entering the loan recoveries as income was "improper" because Welch testified, and Cardinal did not dispute, that instructions for preparing a Federal Reserve call report, a form similar to the SEC 10-QSB, required that loan recoveries be reported in the "allowance account" (i.e., the loan reserve account), not in the income account. Moreover, he found that when Larrowe & Co. corrected these entries in its 2001 annual report to the SEC, Welch's concern that loan

recoveries should not have been entered as income was confirmed. R. D. & O. at 55.

Because the errors in the general ledger were reflected in its 2001 third-quarter 10-QSB report to the SEC, the ALJ found that Cardinal publicly overstated its year-to-date income by $195,000. *Id.* at 56. Thus, he concluded that Welch reasonably believed that the 2001 third-quarter 10-QSB could mislead potential investors because it materially overstated Cardinal's financial status. In reaching this conclusion, the ALJ cited Welch's calculation that including the loan recoveries in the income column of the report improperly inflated Cardinal third-quarter income by 13.7%. He also noted Welch's testimony that a 21% increase in Cardinal stock prices between September 6, 2001, and October 18, 2001, had convinced him that the overstated income "made Cardinal look like it was performing really better than it was." *Id.* at 54.[16]

The ALJ rejected Cardinal's argument that because Welch had previously signed financial statements and call reports without objecting to the entries, he could not have reasonably believed that the ledger entries were improper. The ALJ found that Welch convincingly explained that he had not previously objected because, unlike the SEC report, the financial statements and call reports were not public documents that investors would see and rely upon. Welch also testified that, at the time, he still thought he could persuade Moore to change the financial statements. Furthermore, Welch explained, when the SOX became effective, he could be sanctioned for false certifications, and the new whistleblower provision would protect his employment. R. D. & O. at 57.

Michael Larrowe testified that the third quarter SEC report did not misrepresent Cardinal's financial condition. Larrowe testified that, yes, the result of the journal entries was an overstatement of income on the third quarter SEC report, but the understated loan reserve account offset the income overstatement. Therefore, according to Larrowe, the report gave a fair picture of Cardinal's financial condition the company had $195,000 more at the end of the third quarter than it had before it recovered the two loans. But the ALJ was "more persuaded" by Welch's testimony than Larrowe's because he found certain portions of Larrowe's testimony to be contradictory. *Id.* at 55-57.

Cardinal argues to us that Welch did not have a reasonable basis for believing that it overstated its net income. Br. at 11. To support this argument, Cardinal contends that even if the original decision to enter the loan recoveries as income in the general ledger was an accounting mistake, it does not follow that the SEC report overstated income to date. "In 2001, Cardinal collected certain bad debt in the amount of $195,000. It did not, as it should have, credit[ed] the allowance and then enter[ed] negative entries in the expense line item for provision.' Rather, it classified the $195,000 as forms of income. However, an entry adding $195,000 to income has exactly the same effect on the bottom line as an entry subtracting $195,000 from expenses: they both increase it by $195,000." Br. at 13. "What Welch and the ALJ repeatedly fail to recognize is that, with these $195,000 recoveries on previously written-off accounts, **real money came into Cardinal's door money that was not there before.**" Rebuttal Br. at 3 (emphasis in original). "A reasonable CPA and CFO could not have

concluded that there was an overstatement of net income." *Id.*

Cardinal also argues that the ALJ erred in concluding that Welch engaged in protected activity "because Welch's complaints even if well founded (which they were not) did not allege conduct that constituted a violation of, or even a reasonably perceived violation of federal securities laws. Conspicuously absent from the ALJ's analysis is any explanation of how the conduct complained about constituted a violation of federal securities laws." Br. at 11.

Welch Could Not Have Reasonably Believed That Cardinal Misstated Its Financial Condition

We hold that the ALJ erred as a matter of law in concluding that Welch's concerns about the loan recovery entries and the subsequent third quarter SEC report were protected. As previously noted, the SOX protects employees who report conduct which the employee reasonably believes constitutes a violation of the specified federal securities laws. The "reasonable belief" standard requires Welch to prove both that he actually believed that the SEC report overstated income and that a person with his expertise and knowledge would have reasonably believed that as well.[17] Furthermore, "[b]ecause the analysis for determining whether an employee reasonably believes a practice is unlawful is an objective one, the issue may be resolved as a matter of law."[18]

Although the ALJ did not expressly distinguish between Welch's subjective belief and what a CPA/CFO in Welch's position would reasonably

believe, his opinion implicitly makes both determinations because he wrote, "The standard for determining whether Complainant's belief is reasonable involves an objective assessment." R. D. & O. at 53.

Nevertheless, we conclude that the ALJ erred as a matter of law when he determined that Welch reasonably believed that Cardinal violated the federal securities laws by reporting inflated income in the 2001 third-quarter SEC report. After all, whether or not Cardinal misclassified the loan recoveries as income rather than crediting the loan reserve account, and whether or not stock prices increased 21% between September 2001 and October 2001, and whether or not Larrowe & Co. properly classified the loan recoveries for Cardinal's year-end 2001 SEC report, Cardinal had in fact recovered $195,000 that it previously did not have. Therefore, an experienced CPA/CFO like Welch could not have reasonably believed that the third quarter SEC report presented potential investors with a misleading picture of Cardinal's financial condition. Thus, because the "reasonable belief" test is a matter of law, the ALJ's conclusion about Welch's reasonable belief constitutes legal error.[19]

Welch's Argument About Accounting Standards

On this appeal, Welch, of course, urges us to affirm the ALJ's relevant findings and conclusions concerning his protected activity. But he also contends that when Cardinal misclassified the loan recoveries as income rather than crediting the loan loss account, it violated GAAP accounting standards and accounting rules that the Federal Financial Institutions Examination Council (FFIEC) developed for banks.[20] Welch cites a SOX

provision that directs the Public Company Accounting Oversight Board ("Oversight Board") to adopt rules and other standards that require public accounting firms to evaluate whether covered companies "provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles."[21] Br. at 8, 9 Welch then writes that he "sought at all times material to assure that GAAS [generally accepted accounting standards] and GAAP standards were adhered to by Cardinal in its financial reports relied upon by the investing public. Those accounting standards, when violated, also violate the clear mandate of Sarbanes-Oxley." *Id.* at 9. Thus, Welch seems to argue that these accounting errors were ipso facto violations of the federal securities laws because these standards and the federal securities laws have the same purpose protecting investors from financial misrepresentations. Br. at 8-21.

But this argument amounts to wholesale re-writing of SOX's section 1514A. That section clearly indicates that Congress intended to protect whistleblowers who report about specifically enumerated employer conduct violations of the Federal fraud statutes, SEC rules or regulations, or Federal laws relating to shareholder fraud. According to Welch, Congress, without saying so, must also have meant to extend protection to those employees who report violations of GAAS, GAAP, or FFIEC standards. But Welch has not supported this argument with any authority. Therefore, we reject this argument.[22]

B. Welch's Complaints About Access to Larrowe & Co. Are Not Protected

Relying on Welch's testimony and his memos to Worrell and Moore in August and September 2002, the ALJ concluded that, "Complainant reasonably believed Larrowe & Co. did not sufficiently communicate with him regarding financial matters entrusted to him by his job description but rather went directly to Moore and around [Complainant]." R. D. & O. at 57. Michael Larrowe's testimony that Welch's complaints were due to a "relationship problem" and Larrowe's investigation report finding that Welch chose to play a lesser role were "unconvincing" to the ALJ because Larrowe had an interest in exonerating himself and his firm and had given inconsistent explanations for his failure to tell the Audit Committee that some of Welch's complaints were directed at his own company. *Id.* at 58. Furthermore, Larrowe's own report acknowledged the possibility that Welch's access had been restricted. *Id.* Therefore, the ALJ concluded, Welch's complaints were protected activity.

Cardinal argues that the ALJ erred in concluding that complaints about insufficient access to outside auditors are protected activity. "The ALJ fails to point to a single statute, regulation, or case that holds that an external auditor's preference for communicating with that company's CEO rather than its CFO constitutes securities fraud." Br. at 16. In fact, Cardinal asserts, "[t]he role of the external auditor is to review those reports and submissions for accuracy. It acts as a watchdog over information supplied by management. It does not act as a source of information to management." *Id.* at 16-17.

Welch contends that, "[i]n failing to work with Welch in providing him information to accomplish his function

and comply with the Sarbanes-Oxley certification program, Cardinal and Larrowe & Company defeated the intent of the SEC and Congress that investment decisions by the public be made and based upon accurate and non-misleading financial statements." Br. at 22-23.

But Welch did not prove by a preponderance of evidence how his unhappiness about access to Larrowe & Co. constituted a reasonable belief that Cardinal was violating or might violate the enumerated fraud statutes, any SEC rule or regulation, or any federal law relating to fraud against shareholders. To be protected, an employee's SOX complaint must definitively and specifically relate to the listed categories of fraud or securities violation.[23] Therefore, the ALJ erred in concluding that Welch's complaints about access to Larrowe & Co. constituted protected activity because he does not discuss or make a finding about how insufficient access to Larrowe & Co. relates to the federal securities laws.

C. Welch's Complaints About Inadequate Internal Controls Are Not Protected

The ALJ found that the $195,000 accounting error and Moore's practice of having his secretary, Annette Battle, credit funds earned in one year to expenses incurred in a different year "were part of a pattern that suggested that Cardinal's internal controls were deficient." R. D. & O. at 60. "I find it was reasonable for Welch to believe that too many individuals without financial expertise were making journal entries without the CFO's review and that there were inadequate internal financial controls." R. D. & O. at 59. Therefore,

the ALJ concluded that Welch engaged in protected activity when he repeatedly reported that Cardinal's internal controls were deficient because people without accounting expertise had unrestricted access to the general ledger.

Cardinal argues that even if Welch's complaints about internal controls were valid, they do not constitute protected activity because they do not implicate the federal securities laws. Cardinal again points out that the ALJ cited no authority to support his conclusion that its deficient internal controls caused it to violate the federal securities laws. "Although having a deficient internal control may make an institution more vulnerable to fraud, in itself it is not fraudulent." Br. at 18. We hold that the ALJ erred in concluding that Welch's complaints to Moore about inadequate internal controls constituted protected activity because, again, the ALJ did not discuss how, or make a finding that, the deficient internal control system related to the federal securities laws.

Welch argues that the internal controls themselves were not the problem. According to Welch, the bookkeeping errors about which he complained "occurred not because of a failure in the bank's internal controls, but because those controls were disregarded by Moore and resulted in the financial statements of Cardinal to be unfairly presented." In his September 20 SOX briefing to Cardinal staff, Welch explained that shareholders could be defrauded if his instructions were ignored. "[I]f you do something that [I tell you] is against the law, you're advised of it, and then you refuse to make the correction, then that could be construed as fraud. Because then it's not an accident or

mistake, it becomes an intent to leave things in a deceptive state." T 74-75. Thus, because Moore did not heed his advice, Welch argues that Cardinal violated "the second purpose of the SEC to prohibit deceit, misrepresentations and other fraud in the sale of securities.'" Br. at 27.

We reject Welch's argument that when he complained about Moore's refusal to make the changes Welch wanted, Moore intended to mislead investors. Welch has given us no legal authority for the proposition that rejecting the CFO's advice on accounting matters violates or could reasonably be regarded as violating the federal securities laws. Nor has he explained how merely refusing to accept Welch's advice supports an inference that Moore intended to deceive shareholders.

Conclusion

We reverse the ALJ's conclusion that Cardinal violated the SOX because, as a matter of law, he erred in concluding that Welch engaged in SOX-protected activity. Welch's concerns that Cardinal misclassified the loan recoveries and consequently misled investors do not constitute protected activity because Welch could not have reasonably believed that Cardinal misstated its financial condition. Likewise, Welch's complaints about access to Larrowe & Co. and about Cardinal's internal accounting controls are not SOX-protected activity because they do not relate to the federal securities laws. Therefore, since Welch has not demonstrated that he engaged in protected activity, an essential element of his case, we **DENY** his complaint.

SO ORDERED.

OLIVER M. TRANSUE
Administrative Appeals Judge

M. CYNTHIA DOUGLASS
Chief Administrative Appeals Judge

[ENDNOTES]

[1] 18 U.S.C.A. § 1514A (West Supp. 2005). Regulations implementing the SOX are found at 29 C.F.R. Part 1980 (2006).

[2] Hereafter, we refer to Cardinal Bankshares and the Bank of Floyd interchangeably as "Cardinal."

[3] Witnesses and the ALJ sometimes referred to the two loan recoveries as if there had been a single recovery of $195,000 during the third quarter of 2001. This is a convenient shorthand description of what happened because Welch complained about the fact that Cardinal's third-quarter 10-QSB included the $195,000 in its year-to-date income.

[4] "Loan reserve accounts" are funds that a bank holds in reserve to cover projected losses. *United States v. Whitmore*, 35 Fed.Appx. 307, 314-315 (9th Cir. 2002).

[5] Cardinal and amici Virginia Bankers Association, Virginia Association of Community Banks, and American Association of Bank Directors argue that the ALJ committed error in holding that SOX section 1514A gives whistleblowers the right to be accompanied by private counsel during internal company investigations of their complaints and that the attorney-client privilege would not have applied to

Densmore and Larrowe's interviews of Welch. Inasmuch as the ALJ did not purport to rule that whistleblowers have a right to be accompanied by counsel during internal investigations of their complaints, he did not err. And because the privilege issue is not implicated in our decision here, we need not address the question whether the interviews would have been privileged.

[6] Secretary's Order 1-2002 (Delegation of Authority and Responsibility to the Administrative Review Board), 67 Fed. Reg. 64,272 (Oct. 17, 2002); 29 C.F.R. § 1980.110 (2007).

[7] *See* 29 C.F.R. § 1980.110(b).

[8] *Clean Harbors Envtl. Servs., Inc. v. Herman*, 146 F.3d 12, 21 (1st Cir. 1998), (quoting *Richardson v. Perales*, 402 U.S. 389, 401 (1971)).

[9] *Universal Camera Corp. v. NLRB*, 340 U.S. 474, 488 (1951).

[10] 5 U.S.C.A. § 557(b) (West 1996).

[11] *See Getman v. Sw. Secs., Inc.*, ARB No. 04-059, ALJ No. 2003-SOX-8, slip op. at 7 (ARB July 29, 2005).

[12] 18 U.S.C.A. § 1514A(a).

[13] *See* 49 U.S.C.A. § 42121(b)(2)(B) (iii) (West Supp. 2006). *See also Getman*, slip op. at 8; *Peck v. Safe Air Int'l, Inc. d/b/a Island Express*, ARB No. 02-028, ALJ No. 2001-AIR-3, slip op. at 6-10 (ARB Jan. 30, 2004).

[14] Hereinafter, we refer to these Federal statutes and SEC rules and regulations, collectively, as the "federal securities laws."

[15] *Platone v. FLYi, Inc.*, ARB No. 04-154, ALJ No. 2003-SOX-27, slip op. at 17 (ARB Sept. 29, 2006).

[16] But as Cardinal points out, and the record supports, since the third quarter 2001 report was not filed with the SEC until November 14, 2001, the stock price spike between September 6 and October 18 could not have been the result of the SEC report. Rebuttal Br. at 4; RX 6.

[17] *Melendez v. Exxon Chems. Am.*, ARB No. 96-051, ALJ No. 97-ERA-006, slip op. at 27-28 (ARB July 14, 2000)

[18] *Jordan v. Alternative Res. Corp.*, 458 F.3d 332, 339 (4th Cir. 2006), *cert. denied*, __ U.S. __, 127 S.Ct. 2036 (2007).

[19] *See Jordan*, 458 F. 3d. at 339.

[20] The ALJ did not make findings whether Cardinal violated GAAP or FFIEC standards.

[21] 15 U.S.C.A. § 7213(a)(2)(A)(iii)(II)(bb) (West Supp 2006). Oversight Board rules require independent accountants of publicly traded companies to comply with generally accepted auditing standards. But the Oversight Board did not adopt these rules until 2003, long after Cardinal fired Welch. *See* ww.PCAOB.org/standards/interim-standards/index.aspx.

[22] *See Hall v. U. S. Dep't of Labor*, ARB Nos. 02-108, 03-013, ALJ No. 1997-SDW-005, slip op. at 6 (ARB Dec. 30, 2004) (failure to present argument or pertinent authority waives argument), *aff'd*, 476 F.3d 847, 861 n.8 ("allegations unsupported by legal argument or citation to evidentiary support in the record are insufficient to raise the specific legal theory [appellant] now alleges ARB overlooked"). *Cf.* 2A **Sutherland on Statutory Construction** § 46:4 (N. Singer, 6th ed. 2000) ("A party who asks the court to ignore the plain language of a statute must show that it is manifest that the legislature could not possibly have meant what it said in that language, or the natural reading of the statute would lead to an absurd result").

[23] *Platone*, slip op. at 17. *See also Getman*, slip op. 9-10.

U.S. Department of Labor

Office of Administrative Law Judges
800 K Street, NW, Suite 400-N
Washington, DC 20001-8002

Issue Date: 28 January 2004

CASE NO.: 2003-SOX-15

In the Matter of:

DAVID E. WELCH,

Complainant,

v.

CARDINAL BANKSHARES CORPORATION,

Respondent.

APPEARANCES:

Bruce Shine, Attorney

For Complainant

Laura Effel, Attorney

Douglas W. Densmore, Attorney

Joseph M. Rainsbury, Attorney

For Respondent

BEFORE:

Stephen L. Purcell

Administrative Law Judge

RECOMMENDED DECISION AND ORDER

This case arises under the whistleblower provisions of Public Law 107-204, Section 806 of the Corporate and Criminal Fraud Accountability Act of 2002, Title VIII of the Sarbanes-Oxley Act of 2002, 18 U.S.C. §1514A ("Sarbanes-Oxley") enacted on July 30, 2002. This statutory provision prohibits any company with a class of securities registered under §12 of the Security Exchange Act of 1934, or required to file reports under §15(d) of the same Act, or any officer, employee, or agent of such company, from discharging, harassing, or in any other manner discriminating against an employee in the terms and conditions of employment because the employee provided to the employer or Federal Government information relating to alleged violations of 18 U.S.C. §§1341, 1343, 1344 or 1348, any rule or regulation of the Securities and Exchange Commission ["SEC"], or any provision of Federal law relating to fraud against shareholders.

Procedural Background

David Welch, Complainant, filed an appeal with the Office of Administrative Law Judges on April 29, 2003, from a February 4, 2003 denial of his complaint by the Occupational Safety and Health Administration, U.S. Department of Labor.

A formal hearing was originally scheduled to commence June 25, 2003 at the United States District Courthouse, Roanoke, Virginia. The hearing date was later changed at the request of the parties to August 25, 2003, and the hearing took place as scheduled on August 25th and 26th, 2003. All parties were afforded a full opportunity to adduce testimony, offer documentary evidence, submit oral arguments, and file post-hearing briefs. The following exhibits were admitted into evidence: Complainant's Exhibits ("CX") 1-32, Joint Exhibits ("JX") 1-22, Respondent's Exhibit ("RX") 1-8, and ALJ Exhibit ("ALJX") 1. Post-hearing briefs were received from both Complainant and Respondent on October 20, 2003.

I. ISSUES

1. Whether Complainant engaged in activities which are protected by the Sarbanes-Oxley Act?

2. Whether Respondent, actually or constructively, knew of, or suspected, such activity?

3. Whether Complainant suffered an unfavorable personnel action?

4. Whether Complainant's activity was a contributing factor in the unfavorable personnel action taken against him?

5. Whether Respondent has demonstrated by clear and convincing evidence that it would have taken the same unfavorable personnel action irrespective of Complainant's having engaged in protected activity?

II. SUMMARY OF THE EVIDENCE

David Welch

During his direct examination, David Welch testified that he holds both a Bachelor's degree and a Master's degree (since 1986) in Business Administration from East Tennessee State University (Tr. 24). He passed a Certified Public Accountant exam in 1993 and is currently licensed as a CPA in Virginia. *Ibid.* He began his career in 1991 at Quebecor Printing in Kingsport, Tennessee as a Cost Accountant, was subsequently promoted to a Financial Analyst and, in 1996, became a Senior Cost Estimator (Tr. 25). He left Quebecor during a downsizing in January 1997. *Ibid.* From June, 1997 until August, 1998, he worked as a Controller for a physicians' group at Wellmont Health Systems. *Ibid.* From September, 1998 until February, 1999, Welch worked as a Staff Accountant for Larrowe and Company ("Larrowe & Co."), a CPA firm in Galax, Virginia where he was responsible for bank audits and other accounting matters, and preparing tax returns for corporations and individuals. *Ibid.* Welch also served as an Adjunct Professor at Tusculum College, where he taught finance and strategic planning classes, and at Northeast State Community College, where he taught payroll accounting classes (Tr. 25-26). In February, 1999, he was offered a position as Chief Financial Officer ("CFO") at Cardinal Bankshares, a bank holding company, and its subsidiary Bank of Floyd (hereinafter collectively referred to as "Cardinal" or "Respondent").[1] He continued to work in this position until October 1, 2002 when his employment by Respondent was terminated. *Ibid.* Welch testified that at the time of this hearing, he was employed as a business manager of a

physicians' group in Grundy, Virginia and was also designing courses for an on-line accounting program at Liberty University in Lynchburg, Virginia (Tr. 26).

With respect to how Welch obtained employment with Respondent, he testified that while he was working at Larrowe & Co., Mike Larrowe, a principal of the firm, informed him that one of Larrowe & Co.'s clients was interested in discussing a possible employment opportunity with Welch (Tr. 26). Welch expressed interest in this opportunity, and was subsequently interviewed by R. Leon Moore, the President/CEO and Chairman of the Board of Directors of Cardinal Bankshares (Tr. 27). A few days later Welch accepted an offer to be the CFO of Cardinal. *Ibid.*

Welch testified that during his employment Cardinal was, and presently remains, a publicly traded corporation listed on the National Association of Security Dealers ("NASDAQ") bulletin board. *Ibid.* He explained that Cardinal Bankshares became a "bank holding company" when it bought all the stock of the Bank of Floyd and its subsidiary FBC Incorporated (Tr. 28-29). Welch stated that a holding company was created to allow the Bank of Floyd to take advantage of Cardinal's widely recognized name, with an eye to possible expansion in the future and to enable the bank to transfer part of its capital to the holding company so it could avoid some of Virginia's bank franchise taxes (Tr. 29).During the relevant time period, Cardinal had approximately 600 shareholders and Bank of Floyd was its only subsidiary. *Ibid.*

In his role as the CFO, Welch was responsible for monitoring and reviewing the journal entries that were

posted to the general ledger accounts of the bank and of the holding company. *Ibid.* In addition, he maintained all the general ledger accounts for FBC Incorporated, a subsidiary of the Bank of Floyd. *Ibid.* He was also responsible for the journal entries and all the financial statements for the holding company. *Ibid.* He explained that he was initially apprised of his functions as part of his "on the job training," and, about one year later, a job description was developed for the CFO position which described his duties in more detail (Tr. 28). While he participated in the creation of this job description, he did not draft it, but rather obtained it from Marie Thomas and Shelby Rutherford in the Human Resources office (Tr. 28, 357; CX 35).Welch described his initial experience as CFO as "more or less a swim or drown kind of thing, because I really didn't have any formal training other than the two or three week period that I worked with the previous CFO before he left." *Ibid.*

Welch testified that he became a shareholder of Cardinal when he received three shares of its stock as a bonus in 1999, 2000, and possibly 2001 (Tr. 30). However, he sold all of his shares (12 shares at the time) to another employee in late 2001 or early 2002 because his spouse was a national bank examiner and he was not allowed to hold stock in any bank without obtaining a waiver which required the filing of extensive annual paperwork. *Ibid.*

Welch testified that after he became the CFO of Cardinal, he gained access to its financial information. *Ibid.* He further testified that on January 30, 2002, he wrote a memorandum to Leon Moore stating that Moore was improperly overriding Cardinal's internal

controls (Tr. 119; CX 1). Welch explained that he wrote this memorandum to protest the fact that certain charge-offs were applied to a branch account instead of the Bank of Floyd's account. *Ibid.* According to Welch, this was a violation of the regulatory rules, "because the Federal Reserve says that there should never be a debit balance in the evaluation reserve accounts" (Tr. 121). He testified that he had previously corrected these problems with Moore's approval, however, Moore later spoke with Gardner and Gail Phillips in the Loan Operations Department and told them to reverse the corrective journal entries made by Welch (Tr. at 120).[2]

In October 2001, Welch had some discussions with Leon Moore with respect to the issue of insider trading in Cardinal's publicly traded stock (Tr. 30-31). Welch testified that shortly before the end of October, a woman came into the bank and expressed interest in selling all of her stock in order to pay her electric bill (Tr. 31). Welch stated that she did not know how many shares of stock she owned or what price she wanted, and testified that he "wasn't confident of her mental capabilities to make the decision she was making." *Ibid.* Despite his misgivings, however, Welch looked up the current market price for the stock on the Internet, told the woman what that price was, and she ultimately decided to sell 26 shares at that price. *Ibid.* Welch testified that he then discussed this situation with Moore, who advised Welch that the bank could not buy the stock "because it was too close to the end of a quarter, and what not" (Tr. 32). However, Moore agreed that it would be appropriate for Welch to send an email to all employees advising them of the number of shares available and the price (Tr. 32). Fred Newhouse, Jr., the Executive Vice President of the Bank of Floyd, was

the first to respond andagreed to buy the stock at the price specified by the seller. *Ibid.*

Welch testified that although Moore had signed the certificates sold by the woman and never objected to this sale, he later verbally reprimanded Welch for allowing an officer of the bank to engage in insider trading. *Ibid.* Welch testified that "[w]hen I thought about his reaction to 26 shares, for which there was no price negotiated, it disturbed me that he could overlook his own trades in a similar time window, but accuse someone else of insider trading." *Ibid.* Therefore, on October 30, 2001, Welch wrote a memorandum to Moore confirming the aforementioned conversation (Tr. 33; CX 6). In this memorandum, Welch described the Securities and Exchange Commission's ("SEC") definition of insider trading, and stated that the trades made by Moore and "some of [Moore's] friends" had "fallen very near the shareholders' meeting and quarters-ended in March and September [and] more closely fit [the definition of] insider trading" (CX 6).[3] The memorandum went on to list these transactions, including names, dates, and the number of shares traded. *Ibid.* Welch testified that one such transaction involved a purchase by Moore of 420 shares on October 1, the day after the quarter ended, which, according to Welch, was more problematic than Newhouse's purchase of only 26 shares in advance of the quarter end (Tr. 33). Welch added that he was also concerned with this transaction because it took place during the same quarter in which the earnings were overstated by nearly 14 percent due to two entries (discussed below) totaling $195,000 which he believed to be improper (Tr. 136).

In this memorandum, Welch also listed Moore's purchase of 243 shares, which Welch believed at the time had taken place on April 19, 2001, only six days prior to the announcement by Cardinal of a three for one stock split scheduled for April 25 (Tr. 33; CX 6). Welch acknowledged that during discovery in this case he learned Moore had in fact issued a check to purchase these shares around March 9, 2001 (Tr. 34; RX 2). He testified, however, that the information he had in April "gave the appearance of inappropriate activity" (Tr. 35). He further explained that, as Cardinal's transfer agent in charge of reviewing the paperwork for all stock trades, he knew only that an order to issue stock in Moore's name was dated April 19, 2001,[4] and this timing justified his concern over the transaction as Respondent's CFO (Tr. 38; RX 2). He added that Moore did not tell him when he had issued a check, and instead stated simply that he cleared this trade with an attorney and accountant(Tr. 39, 136). To this Welch replied that "if that was the quality of advice . . . he was receiving he might consider a second source of opinion." *Ibid.*

Welch further testified that the fact Moore issued a check in March for the stock purchase made no difference because, according to Welch, on March 9th Moore was already aware "that a stock split was pending" (Tr. 35). He explained that as President, CEO, and a Board member, Moore knew about the stock split long before April 19th, and traded in stock before this information was made public (Tr. 33-34). He added that the stock split had been discussed for several months, but could not specify when the final decision was made. *Ibid.* He explained that "[s]ince a stock split doesn't occur that frequently most times it's a discussion that

takes place over an extended period of time. It's normally not . . . [a] spur of the moment decision, such as the Board meeting . . . the week before the shareholders meeting where the split [is to be] announced . . . . [The Board members] would have had to [seek] advice from external auditors or from other sources of what impact a stock split would have on the price of the stock[,] . . . on the sales or the ability to raise additional capital. So, it would have taken a fairly significant amount of time to gather all that information to come to the final decision . . . ." (Tr. 36-37). Welch testified that Moore never again raised the issue of insider trading with him (Tr. 40).[5]

Welch also testified regarding his efforts to report the alleged insider trading incidents.[6] He testified that in addition to discussing his concerns with Moore, he also reported them to the SEC by email around March 29, 2002 (CX 12, 13).[7] In the document offered by Welch into evidence as his email to the SEC, Welch stated that as CFO and Transfer Agent for Cardinal he had observed a number of questionable activities involving Leon Moore, including stock purchases that Welch classified as insider trading and improper journal entries totaling $195,000, which inflated Cardinal's earnings. *Ibid.* The letter also stated that "Mr. Moore operates under the assumption that when he yells, everyone tucks their tails and run," and that Welch refused to be Moore's "Yes man," even though he realized that "this will most likely cost me my job." *Ibid.*

Welch further testified that since Sarbanes-Oxley was enacted on July 30, 2002, he engaged in the following activities that he believed were protected under the whistleblower provisions of the Act: On

August 2, 2002, Welch wrote a letter to Beth Worrell of Larrowe & Co., the auditor in charge of the Bank of Floyd and Cardinal Bankshares audits, informing her that he "could not sign the representation letter as they had presented it because there were at least three items that had problems" (Tr. 122; CX 17). In addition, in August, 2002, he sent an email to Fred Doyle, examiner for the State Corporation Commission's Bureau of Financial Institutions (Tr. 123; CX 14). On August 14th, 2002, he sent a memorandum to Moore informing him that he could not certify the financial statements contained in the 10-QSB for the second quarter of 2002 and explaining the reasons for his refusal (Tr. 121-22; CX 20). *Ibid.* On September 13, 2002, he sent a second memorandum to Moore describing the same problems (Tr. 122; CX 23). Finally, on September 20, 2002, he conducted a meeting with some of Cardinal's officers on the Sarbanes-Oxley Act (Tr. 123; CX 25-27).[8] Each of these activities is detailed below.

In August 2002, Welch expressed to Beth Worrell, of Larrowe & Co., several concerns with respect to a "representation letter" prepared by Larrowe & Company for his signature. The representation letter amounts to an acknowledgement by Welch, on behalf of Cardinal, that Cardinal, *inter alia*: is responsible for the fair presentation in the consolidated financial statements of certain financial information in conformity with generally accepted accounting principles; has made various financial and other records available to Larrowe & Company; and confirms there have been no violations or potential violations of laws or regulations, or irregularities involving management or

employees (CX 17 at 2-3). In an August 2, 2002 letter from Welch to Worrell, Welch wrote, in part:

I received your e-mail with the representation letter attachment and I am returning it unsigned for three reasons.

1. All too often, journal entries (that should have prior review) are made by persons outside the Finance Department without the CFO's review or knowledge.

2. I cannot respond affirmatively on all items listed in the representation letter.

3. Over the course of my tenure as Chief Financial Officer at [Cardinal] . . . , Larrowe & Co. hascommunicated primarily with Leon Moore "on all issues. In fact, in the 10Qs and 10Ks you prepare, Leon is listed as the financial officer. Over the past year to year and a half, I have been excluded from your communications loop almost entirely. Not having access to all the necessary information, I cannot attest to the validity of all entries included in our financials.

During the first half of 2002, the media has made us acutely aware of corporate wrong doings. As a result, this past Tuesday, President Bush signed into law a bill that contains some pretty harsh penalties for accounting practices that could result in financial statements being unfairly presented. As a result, I need a better level of comfort before signing a representation [letter] such as yours.

(CX 17 at 1). Welch explained that the text of the representation letter was prepared by Larrowe & Co.

(Tr. 358). He also testified that he personally mailed his August 2nd letter via the U.S. Postal Service and enclosed in the same envelope an unsigned copy of the representation letter, in which he incorporated references to the three objections listed above (Tr. 358; CX 17). Specifically, he inserted a bolded, underlined, and capitalized reference stating "see my letter dated 08/02/02 (attached) for response to this item" under the provisions certifying: the absence of irregularities involving management or employees who have a significant role in internal controls; a lack of irregularities involving other employees that could have a material effect on the financial statements; and the absence of violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements (CX 17 at 2).

According to Welch, he had also briefly described his concerns over irregularities at the bank to Fred Doyle, a bank examiner, and subsequently sent him an email inviting Doyle to contact him after hours at home to discuss these concerns in detail (Tr. 123, 138; CX 14).[9] Welch explained that his email to Doyle did not specify the nature of his concerns because he was worried about Doyle showing it to Moore. Instead, Welch wanted to meet personally with Doyle and discuss his concerns confidentially (Tr. 138-39). Welch added that he later had reason to believe Doyle actually talked to Moore about Welch's concerns because "at a staff meeting not long after the examiners left Mr. Moore made a statement . . . that someone had gone to the examiners, and if I remember correctly said, with a pack of lies. And if there w[ere] any problems they should be addressed with him and people should remember who signs their paychecks" (Tr. 156).

He testified that he wanted to report his concerns to Moore and the bank examiner because they "had the responsibility to report to the Board of Directors or the Audit Committee, [and he was] hoping at least one of them would step forward and do their jobs and make the report" (Tr. 139). He added that it was not his responsibility to report to the Board and Committee because "when your boss is the President and CEO and Chairman of the Board you can't very well go charging into the Board Room and make accusations. Because I feared for my job from the beginning. I wanted someone outside who had independence, who had authority to come in and investigate my questions" (Tr. 140). He acknowledged that he never reported his insider trading concerns to any member of the Board of Directors or Audit Committee, with the exception of Moore, who was a member of both bodies. *Ibid.* Welch could not recall whether the insider trading issue was ever discussed at senior managers' or officers' meetings, but stated that, if it was, the internal auditor would have been present who had a duty to report it to the Audit Committee (Tr. 140-41).

In his August 14th memorandum to Moore, Welch cited the following reasons for refusing to certify the Form 10-QSB for the third quarter (ending June 30, 2002) (CX 20). He first noted that "[a]fter attempting to tie Larrowe and Company's figures to our FR Y9LP, FR Y9C and Cardinal's Consolidated financials for June 30th, I am unable to reconcile their numbers to ours." *Id.* at 1. He further stated that he had told Moore repeatedly that too many people were "making journal entries without [his] knowledge or approval," citing as an example the two entries totaling $195,000. *Ibid.* Welch also objected to an entry authorized by Moore at

2001 year-end "charging $4,500 in expenses against 2001 income," which was later reversed (in May). *Ibid.* Welch asserted:

The result of these two sets of entries was a decrease in taxable income in 2001, a decrease in expenses in 2002 and an increase in net income for 2002. We discussed this practice the first year I came here. As I said then, this type of accounting does not meet GAAP ["Generally Accepted Accounting Principles"]. It also hints at "managing" net income which has always been unethical and is now seriously illegal.

Ibid.

Welch's testimony then turned to a memorandum he wrote to Moore on September 13, 2002, to which he attached two certification forms that Sarbanes-Oxley requires companies to file with their Forms 10-QSB (CX 23). Welch explained that a Form 10-QSB is a "group of financial statements that a publicly traded company [is] required to file with the [SEC, including] . . . a statement of operations, or income statement; balance sheet; statement of cash flows; shareholders - change in capital based on shares bought and sold; and other financial statements as well as commentaries of the companies" (Tr. 42). Welch further explained that one of these certifications (hereinafter the "initial certification") was required only for the first Form 10-QSB submitted after Sarbanes-Oxley was enacted and thus had to be filed with Cardinal's June 30, 2002 Form 10-QSB[10] (Tr. 42-43; CX 23 at 8, 9). According to Welch, although this initial certification required the signatures of both the CEO and CFO, Welch refused to sign it (Tr. 43-44). Instead it was signed by Moore alone

and was filed separately from the Form 10-QSB (Tr. 44). Welch testified that subsequent certifications had to be submitted each quarter with Forms 10-QSB starting on September 30, 2002 (hereinafter "third-quarter certification") and required only the CFO's signature, which Welch also refused to provide (Tr. 43; CX 23 at 2). According to Welch, Cardinal had to file its first quarterly certification on either November 14th or 15th of 2002 (Tr. 133).

In his September 13th memorandum to Moore, Welch stated, in part:

Two weeks from Monday, the 3rd quarter will be ending. Shortly thereafter, another 10-QSB will be due. It would be my preference to avoid the friction experienced last quarter. . . . I have attached a Section 302 certification that contains the verbage (sic) required by the Sarbanes-Oxley Act of 2002 along with explanatory notes. The Section 302 certification is required each quarter beginning with the September 30, 2002 10-QSB. It is also required to be part of the 10-QSB rather than being filed as a separate document. This is to assure its availability to anyone who wishes to review Cardinal's financials.

The first copy of the 302 certification is as it should be submitted except for the signature and date. The second copy has key phrases underlined and in bold type. Each of these phrases is connected to a comment box which has a brief explanation as to why I will not be able to certify the 3rd quarter's 10-QSB.

The certification submitted with your "signature" last quarter will not suffice this quarter for two reasons.

First, the Section 302 certification noted above must now be submitted. Second, there are material items in the 2001 3rd quarter YTD figures that should be restated. The restatement should be done in order to avoid the unfair presentation of financial statements which could lead a reasonable investor to make a decision they might otherwise not make.

I would like to address these issues with you today so you can have something to think about over the weekend.

(CX 23 at 1). The copies of the initial and third-quarter certification forms attached to the September 13, 2002 memorandum contained Welch's comments explaining his reasons for not signing these forms, with arrows pointing to the corresponding parts of the certification (CX 23). In addition, for each part of the third-quarter certification that Welch felt was not satisfied, he included in his memorandum a section entitled "Comments or Recommendations" (CX 23 at 3-7).

The annotated initial certification to which Welch referred in his memorandum stated that, for the quarterly report for the period ending June 30, 2002, as filed with the SEC, the undersigned CEO and CFO were certifying, based on their knowledge and belief, that: "(1) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of and for the periods covered in the Report" (CX 23 at 8).[11] Welch's annotations on the form with respect to this

certification quote the Sarbanes-Oxley provision that "whoever willfully certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $5,000,000, or imprisoned not more than 20 years, or both." *Ibid.* His comments on the form also note that the initial certification submitted by Cardinal "fail[ed] two tests: (1) it does not contain both signatures [as the CFO's signature was missing], and (2) it was submitted knowing that there were issues with fair presentation and accuracy;" that "[n]o attempt was made by CEO to bring the financial statements into compliance;" and that "[t]he issues noted in a memo to the CEO were not discussed with the CFO." *Ibid.*

A copy of the third-quarter certification attached to Welch's September 13th memorandum is more detailed and contains several critical comments made by Welch, which indicate that five out of six parts of the certification had problems that prevented him from signing it (CX 23 at 2; Tr. 45-46).[12] Paragraph two of the certification contains the following language of the Sarbanes-Oxley: "Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact, or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report" (Tr. 48; CX 23 at 2). With respect to this paragraph, Welch's annotations noted the following reason for his refusal to certify this part: "3rd Qtr 2001 income should be restated to properly account for the $195,000 recoveries" (CX 23 at

2). In his comments attached to the annotated form, Welch further explained this comment as follows:

In June and July of 2001, we received two recoveries [of $45,000 and $150,000] on loans that had been written off . . . . When these monies were received they should have been given to me with an explanation as to what they were for. Instead of booking them improperly as income, I would have booked both . . . amounts to the Valuation Reserve.[13]

As it occurred, the entries were made by someone not having the appropriate knowledge relating to generally accepted accounting principles, FFIEC guidelines or IRS regulations. As a result, when I found the entries during my monthly G/L review, I brought them to your attention to get the entries changed.

Over the course of the last six months of 2001, I brought this issue to your attention at each of our Senior Officer meetings. Each time, you disagreed with my opinion and with the regulation and refused to change the entries. At year-end, Larrowe & Co. made the changes as I had previously recommended.

As a result of these incorrect entries, Net Income, after income tax effect, was overstated by 13.7% for the third quarter of 2001 and 7.4% for the YTD September 30, 2001.

Net Loans were overstated by $195,000 (only 0.2%); Valuation Reserves were understated by $195,000 or 14.1%; Other Liabilities were overstated by $66,300 or 17.4%; and Retained Earnings were overstated by $128,700 or 4.5%.

Therefore, the Income Statement, Balance Sheet, and Cash Flow Statement for the third quarter of 2001 should be restated to accurately reflect the results of operations, financial conditions, and cash flows (see attached sample Income Statement and Balance Sheet).

(CX 23 at 3; Tr. 49).

Welch testified that, in his opinion, the aforementioned effects were material and a sudden increase in the stock price between early September and late October, 2001 convinced him that "these overstatements in income made Cardinal look like it was performing really better than it was," since he could not identify any other explanation for this increase (Tr. at 49). In fact, a stock transfer log prepared by Welch reflects a 21 percent increase in the price of stock after the third quarter report for 2001 from $13.00 per share on September 6, 2001 to $15.75 per share on October 18, 2001 (Tr. 50; CX 5). Welch testified that because he considered this increase to be material, he concluded that these entries constituted untrue statements that did in fact mislead investors (Tr. 50-51). Welch further testified that he did not tell Moore that he (Welch) could not provide a certification, but rather his comments were intended to inform Moore that the financial statements included with the initial certification "needed corrections in order to meet the requirements of Sarbanes-Oxley to avoid the potential penalties" (Tr. 45, 48). As noted below, Welch considered corrections eventually made by Cardinal's management with regard to the $195,000 recoveries to be insufficient.

Welch further testified that the resulting income increase was not offset by an expense increase:

When the checks were received and deposited there was a debit to cash and a credit to the income accounts, either the other income or the other real estate income. Those were the only two entries. There were not any offsetting expense entries. It was a debit to cash and a credit to income.

(Tr. 359-60). Accordingly, there was no "wash" in the third quarter of 2001 (Tr. 360).

Welch further testified he believed the fact that Wanda Gardner, Respondent's Vice President and Internal Auditor, made the aforementioned entries for $45,000 and $150,000 was also problematic because "the internal auditor should not be making journal entries to the general ledger when she's going to be responsible for possibly auditing those same numbers. So, there's no independence there" (Tr. 53-54). Welch added that he later learned that Moore was the person who had instructed Gardner to make these entries (Tr. 54).

With reference to paragraph two of the third-quarter certification, Welch's attached comments also recommended that Respondent "[a]bide by the policies that my job description implies are in existence" and "allow me to follow these policies" (CX 23 at 4). Welch cited the following examples of duties, apparently derived from his job description: "[c]omplies and analyzes financial information to prepare entries to accounts, such as general ledger accounts, documenting business transactions;" "determines proper handling of financial transactions and approves transactions within

designated limits;" and "monitors compliance with generally accepted accounting principles and company procedures." *Ibid.*

Paragraph three of the third-quarter certification states, in part: "Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operation and cash flows of the registrant as of, and for, the periods presented in this quarterly report" (CX 23 at 2). Welch testified that he could not certify this part for the same reason he refused to certify paragraph two (Tr. 51-52; CX 23). He stated that on at least two occasions he attempted to convince Cardinal's management to correct this problem at the senior managers' meetings in the presence of Moore, Gardner, Compliance Officer Diane Hamm, and other employees (Tr. 53-54). Welch further testified that, after performing the year-end audit of Cardinal, Larrowe & Co. ultimately acknowledged that Welch was right (Tr. 54-55). Specifically, in January 2002, Beth Worrell, the auditor for Larrowe & Co., investigated Cardinal's accounts for inappropriate entries and reversed the two aforementioned entries totaling $195,000 disputed by Welch, after Welch directed her attention to these entries (Tr. 55). However, according to Welch, these reversals corrected only the misstatement of income for the year end, but not for the third quarter of 2001 (Tr. 55-56). According to Welch, this is problematic because under the existing requirements, "the third quarter's income statements and balance sheets [for 2001] would appear in the following year in the third quarter of 2002 as comparative statements" relied upon by the investors (Tr. 56, 71). Welch testified that prior to their

meeting on September 20, 2002, he recommended to Moore that this mistake be corrected by restating the financials, but it was never done (Tr. 56-57).

Finally, with reference to paragraph three of the third-quarter certification, Welch included the following recommendation: "permit me to perform the job functions as outlined in my job description," including those listed under part two above, as well as the following: "audits contracts, orders, and vouchers, and prepares reports to substantiate individual transactions prior to settlement," and "reviews, investigates, and corrects errors and inconsistencies in financial entries, documents, and reports" (CX 23 at 4).

Paragraph four of the third-quarter certification states in relevant part: "The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in [the Act] for the Registrant and have; (a) designed such disclosure controls and procedures . . . ; (b) evaluated [their] effectiveness [within] 90 days prior to the filing date of this quarterly report . . .; and (c) presented in this quarterly report our conclusions about [their] effectiveness . . . ." (Tr. 57; CX 23 at 2). Welch's attached comments state that "[Larrowe & Co.] communicates exclusively with CEO on all disclosure matters" (i.e., to the exclusion of Welch), that Welch had not "participated nor been consulted in the design of disclosure controls and procedures, and that [he] has not evaluated their effectiveness" (CX 23 at 2). With respect to Welch's attached comments regarding paragraph four, he provided the following recommendation: "[p]ermit me to review the disclosure

controls and procedures you have put into place in order to evaluate their effectiveness" (CX 23 at 5).

Welch testified that after the Sarbanes-Oxley Act was signed into law on July 30, 2002, he informed the management that he would not be able to make this certification because Cardinal had not complied with its requirements (Tr. 57). He further testified that, to his knowledge, no disclosure controls and procedures had been designed (Tr. 58). Welch stated that he was aware in August 2002 that disclosure controls had to be designed in time for the third-quarter certification due in mid-November, but he repeatedly testified that he did not believe that designing these controls was his responsibility as the CFO (Tr. 58, 131-34). He explained that designing this system was, he believed, the responsibility of the external auditors since: (1) it was their job to determine whether the necessary financial information had been fairly disclosed when they prepared the annual audit report and reviewed Forms 10-QSB and 10-KSB; and (2) the Act itself imposed this responsibility on the senior management and external auditors (Tr. 133-34).[14] He later testified that he at least expected the external auditors to provide guidance on this matter, because he would not be able to determine what disclosures were required without their assistance (Tr. 130-31, 133). Welch explained that he was not in a position to determine specifically what had to be done to comply with the Act's requirements despite having attended a CFOs' conference on the Sarbanes-Oxley Act on September 9th and 10th, 2002[15] because the conference was short (approximately an hour and a half long) and focused mainly on the highlights of the Act and the required certifications (Tr. 74, 95-96, 130). He added that the language of the certification did not

suggest to him he was the individual responsible for designing controls, and when he wrote the August 14th memorandum he knew little about the requirements of the Act which had only been in effect for two weeks (Tr. 131).[16] Besides, according to Welch, his memorandum was not attempting to resolve "whose responsibility it was, it was just these things need to happen before certification can go forward. And at this point some of the guidance, final guidance, had not been issued" (Tr. 131-32). He acknowledged, however, that he never asked Mike Larrowe for help with designing controls (Tr. 134).

Paragraph five of the certification states: "The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee or registrant's board of directors . . . : (a) all significant deficiencies in the design or operation of internal controls . . . ; and (b) any fraud, whether material or not, that involves management or other employees who have a significant role in the registrant's internal controls" (CX 23 at 2). Welch's comment for this part states: "No evaluation. The CFO isn't permitted to address Audit Committee or Board." *Ibid.* His comment referencing sub-part (a) indicates that: "[o]nly the deficiency of too many non-accounting people making [journal entries]w/o Finance review or approval has been brought to the attention of CEO & External Auditors.[17] Dual control does not make an entry meet GAAP." [18] *Ibid.* Welch clarified that the "internal control system is the guidelines by which journal entries . . . get into the general ledger" (Tr. 61). He explained that although Cardinal used the dual control system for approving such entries, he was not given a

chance to review such entries, as required by his job description. *Ibid.* According to Welch, such entries often failed to follow the generally accepted accounting principles, as did the $195,000 recovery and some "sundry expenses," because they were made and approved by people outside the Finance Department who did not have the financial expertise necessary to determine whether those entries satisfied such accounting principles (Tr. 61, 63-64; CX 15).[19]

Also with reference to sub-part (a) of paragraph five, Welch's memorandum stated, in part:

Since you [i.e., Leon Moore] are the only person who reports to the board and I have been instructed by you not to address the audit committee and you have been the (practically) exclusive contact with Larrowe & Co., I cannot certify any portion of this statement.

This is not a situation seen in very many banks. Most banks have at least two officers on the board for purposes of accountability as well as for providing diversification of opinion on . . . operational issues that come before the board.

(CX 23 at 5).

With regard to the sub-part (b) requirement to disclose all fraud, Welch's comments state "if insider trading is fraud, it has been reported to CEO" (Tr. 66; CX 23). Welch testified that he found it significant that mishandling even small amounts of money would violate Sarbanes-Oxley as long as there was "the intent to deceive." *Ibid.* He added that, in his opinion, the aforementioned journal entries and insider trading

constituted fraud. *Ibid.* The attached comments also asserted that, as Welch had previously indicated to Moore, "the practice of making credit entries to Sundry Credits (liability account) and debit entries to Sundry Expenses at year-end . . . are misleading to the financial statement reader" (CX 23 at 6). He went on to say that even more misleading were the entries made in the following year that reversed the sundry credits entries (debits) and reduced the expense accounts because "[a]s a result of this second set of entries, it appears that expenses for the second year are less than they actually were, thus, overstating income in the second year" (CX 23 at 6; Tr. 64-65). Welch asserted that this practice was inconsistent with generally accepted accounting principles which require "that income and expenses be matched against the period in which they are incurred." *Ibid.* During his direct examination, Welch testified that this practice had "the appearance of manipulating income" or "pump[ing] up" earnings at mid-year, "which is a significant milestone for investors." *Ibid.* Welch further testified that this practice was "something that all the regulators strictly prohibit" (Tr. 65). In particular, "according to FASBE 140[20] the only way to reverse those entries legally was either the debts were paid, the expenses were paid, or it's released by a Court of law or by judicial action" (Tr. 358-59). Instead, they were reversed when "around the middle of the following year, there were credit entries made to various expense accounts and debits made to the sundry credits account" (Tr. 359). Welch testified that such reversal was not appropriate because "it did not constitute payment nor did it constitute judicial release of the liability" (Tr. 359). Welch's comment under sub-part (b) again reiterated that Respondent needed to

permit him to perform the job functions outlined in his job description (CX 23 at 6).

Even prior to the September 13th memorandum, according to Welch, he had brought to Moore's attention the aforementioned problems concerning paragraphs two through five of the certification (Tr. 66). He also stated that since Moore served as the Chairman of the Board of Directors, was President and CEO, and a member of the Audit Committee "in all those roles he was the conduit for information to the Audit Committee, to the Board of Directors" (Tr. 67-68).

On September 13th, 2002, Leon Moore wrote a memorandum responding to Welch's September 13th memorandum, stating, in part:

I am well aware of the certification process and I am well aware of the needs that you have discussed. Please review all of the notes that you have made and expound on those in more detail. Give me any suggestions that you have on each of those. I too want to avoid friction or misunderstanding such as we experienced last quarter. You must understand that these reports will be certified. In the future, to enhance communications, your memos will need to be presented in person for discussion.

(CX 22).

Despite his refusal to sign the initial and third-quarter certifications, Welch acknowledged that prior to the enactment of the Sarbanes-Oxley Act he signed consolidated financial statements and reports of

condition (call reports) relating to the bank and its holding company which were filed quarterly with the Federal Reserve (RX 7 and 8).[21] Welch testified that he realized at the time that some of these reports were inaccurate, but did not report these problems because

[A]t my age it's difficult to change careers and I believed before Sarbanes-Oxley came along that what has happened to me would have happened. I would have been terminated. I would have been in a position with the gap of my employment as a Chief Financial Officer at a bank which would raise questions with potential employers. Apparently that's what has happened, because for six months after my termination. After dozens and dozens of applications and resumes there were no contacts from anybody, even for interviews. Until Sarbanes-Oxley came along I didn't feel like I had any legal standing to support my positions or to protect me.

(Tr. 141-42).

Welch gave several additional reasons why he signed these financial reports yet refused to sign the aforementioned certifications. First, he testified that, at the time the 2001 call reports for the second and third quarter were prepared, he had not yet discovered the inappropriate entries for the $195,000 recovery. He further stated that, even after he found these entries, he signed a call report because he was still convinced that he could persuade Moore to make the necessary changes (Tr. 70-71; CX 8). Second, Welch testified that, unlike Forms 10-QSB, the call reports are not public documents relied upon by investors and do not contain comparative statements (Tr. 71). Third, Welch pointed

out that different reports require different levels of review (Tr. 69-70). In particular, the call reports, unlike Forms 10-QSB, required him merely to review the financials for any "significant" problems, and the other reports he signed contained no certification or review requirements (*see e.g.*, RX 8 at 5) (Tr. 69-70, 71-72).[22] By contrast, the Sarbanes-Oxley Act, which pertains to the quarterly report (Form 10-QSB) and the annual report (Form 10-KSB), required a certification that all statements are accurate and not misleading, and provided for significant fines and prison terms for violations (Tr. 72). Welch stated that the Act not only exposed him to this risk, but also promised to protect his employment, and provided him with the legal authority to back his position. *Ibid.*

On September 17, 2002, Cardinal's board of directors held a meeting to address the allegations raised by Welch in his September 13, 2002 memorandum. The minutes of the meeting reflect that it was attended by Moore, Larrowe, Gardner, K. Venson Bolt, who was Vice Chairman of Cardinal and Chairman of the Audit Committee, and Cardinal's attorney Douglas W. Densmore (CX 33[23] at 1). Moore opened the meeting by reading Welch's September 13th memorandum and a response prepared by Moore to Welch bearing the same date. Moore stated that the allegations Welch made in his memorandum were unfounded and, in part, reflected Welch's own failure to do his job and his deteriorating relationship with the company. *Ibid.* Moore reported that difficulties with Welch began approximately two years ago when Welch instructed Larrowe & Co. to review a Form 10-QSB and other financial reports prior to their filing. *Ibid.* Since that time, Welch became increasingly "disaffected and

apparently unwilling or unable to do what needs to be done to comply with the law." *Ibid.*

Moore cited several areas of concern to the board regarding Welch's performance. First, he stated that in August 2002, state bank examiners had cited fifteen errors in the second quarter call report, which Welch blamed on Larrowe & Co. and on the fact that he was out on sick leave when the report was filed. *Ibid.* According to Moore, the examiners were concerned that no one in the Financial Department was trained to act as a backup to Welch. *Ibid.* Moore further stated that he had repeatedly instructed Welch prior to the state examination regarding the need for backup training, but no training took place even though there were individuals who were willing and able to be trained. Moore further reported that the Bank had purchased software at the cost of $4,000 that would enable the ITI system to interface with and load information into the call report. *Ibid.* Although Welch was instructed to work with the Data Processing Manager on implementing this new software, he refused to use it and continued to manually enter data into the call report using Excel spreadsheets. *Ibid.* The examiners had, according to Moore, also noted that many of the charts, graphs, and spreadsheets prepared by Welch were unnecessary and time-consuming. *Ibid.*

Moore's second concern related to Welch's allegation that figures had to be corrected for the purposes of filing the 2001 third quarter Form 10-QSB, including the aforementioned entries totaling $195,000. *Ibid.* Moore stated that no fraud was involved, that recoveries and charge-offs had always been placed in income accounts, and that "entries made at the end of

the year had been reversed" based on the calculations made by the Credit Analyst. *Ibid.* Moore asked Larrowe to review Welch's allegations and make a recommendation as to whether a restatement of Form 10-QSB for the 3rd quarter 2001 was necessary. *Ibid.*

Finally, Moore reported that he was also concerned with the lack of "depth" in the Financial Department under Welch, which resulted in excessive reliance on internal and outside auditors for help. *Ibid.* Moore stated that SEC regulations "are forcing external auditors to step away from certain functions they performed in the past, and this could present a problem . . . in the future, unless in-house expertise was available." *Ibid.*

The minutes of the September 17th meeting further reflect that after Moore concluded his presentation, Densmore discussed Welch's concerns. *Ibid.* Densmore pointed out the need to research the figures for the third quarter of 2001 to determine if Welch was correct in stating that the Form 10-QSB for that quarter required restatement. *Ibid.* He further stated that the Board had to either terminate Welch based on his inability to do his job, or remind him of his job responsibilities. *Ibid.* He warned, however, that if the latter approach was taken and Welch's performance did not improve, Cardinal would have little time to correct any problems. *Ibid.* He also discussed the need for an adequately performing CFO and the potential ramifications of terminating Welch at that time (CX 33 at 3). Finally, Densmore advised that the following steps be taken under the auspices of the Audit Committee:

1. Discuss with Welch the nature and extent of his concerns and investigate them, and take corrective action to the extent Welch's concerns are substantiated.

2. Determine if Welch is correct about the need to restate the figures for Form 10-QSB for the 3rd quarter of 2001, and, if so, make the corrections.

3. Discuss the situation with the MountainBank Financial Corporation to avoid problems under the merger agreement.

Ibid.

Subsequently, Venson Bold asked Densmore and Larrowe, on behalf of the Audit Committee, to meet with Welch, investigate his concerns, and provide a written report to the Committee. *Ibid.* Moore approved of this course of action, and Densmore stated that he and Larrowe would not involve Moore in the investigation since some of Welch's issues related to Moore. *Ibid.*

Welch testified that Moore's list of concerns regarding his performance contained several inaccuracies.[24] First, Welch stated that he did not blame Larrowe & Co. for the errors in the call report since he had personally prepared the report and submitted it on April 12th, before going on sick leave on April 15th (Tr. 111). He also denied there was any lack of back-up training, stating that in the third and fourth quarter of 2001 he had been training Patricia Spangler and giving her progressively more responsibility in the preparation of call reports using the DPSC Software (Tr. 111-12). In the fourth quarter of 2001 and the first

quarter of 2002, Welch felt that Spangler was ready to work with very little supervision (Tr. 112). Welch added that he had asked for and received approval for his three female co-workers to take Accounting 101 and 102 courses. *Ibid.* Also, according to Welch, at three consecutive senior officers' meetings in late 2001 he provided detailed "training lists" for each individual in his department (Tr. 113). Regarding his purported failure to implement the newly acquired DPSC software, Welch testified that, before it was purchased, Cardinal did not have a reliable system for transferring information to the call reports, so he had no choice but to use Excel worksheets. *Ibid.* However, the data processing manager was working with him and Patricia Spangler on improving the transfer of information "to the point that in the first quarter of 2002 probably 80 percent of the numbers from the mainframe could automatically be transferred into this reporting software. So, progress was being made and . . . the Excel worksheets that I had designed over the previous two years were used less and less" (Tr. 113-14).

Welch testified that on Friday, September 20, 2002, he conducted and tape recorded a meeting with Leon Moore, Wanda Gardner, Fred Newhouse, Jr., Marie Thomas (Vice President of Human Resources), and Annette Battle (Executive Secretary and Secretary to the Board) (Tr. 72; CX 25). According to Welch, he called this meeting in order to discuss his aforementioned concerns[25] and was motivated by his belief that failure to correct known problems could be construed as fraud under Sarbanes-Oxley, while prompt corrective action could help avoid deception and liability (Tr. 74-75).[26]

At the commencement of the meeting, Welch informed all the participants that he was going to make a presentation on the Sarbanes-Oxley Act and describe the potential penalties they faced individually and as a company if the statute was violated (Tr. 73; JX 2;[27] CX 26 at 1).[28] He further testified that when he informed those present he intended to tape record the meeting based on the advice of his attorney, Moore, citing "bank policy," attempted to turn off the tape recorder (Tr. 75).[29] Welch stated that he turned the recorder back on and said he was willing to suffer the consequences because his statements had often been misconstrued in the past (Tr. 76). Welch further stated that Moore was "very upset with the direction of [Welch's] discussion" (Tr. 81). After talking to Densmore on the phone, Moore announced that the meeting was terminated pursuant to Densmore's advice, and ordered everybody to leave the meeting. *Ibid.* Welch testified he told Moore that, as the President/CEO, he had the authority to tell employees what to do, but that he, Welch, "still had the fiduciary responsibility" to advise the bank's employees of "potential problems that they might encounter if they didn't hear about Sarbanes-Oxley." *Ibid.* The transcript of the tape recording reflects that Welch also stated: "over the past three and a half years, just like now, my opinions are discounted;" there were three people in the room whom he believed were "parties to fraudulent acts;"[30] and if Moore, Gardner, and Battle chose to leave the meeting, they would not learn about their roles in the violations (JX 2 at 2, 4). Moore and Battle then left the meeting, while Thomas, Newhouse, and Gardner remained (Tr. 82).

The transcript also reflects the following statement by Welch: "As bank officers, we have a fiduciary

responsibility to look after the shareholder's interest and based on this responsibility, I have taken a stand on the new financial reporting legislation called the Sarbanes-Oxley Act of 2002. Later, as each of you reviews the material covered, you'll have to take your own position . . ." (JX 2 at 1). Welch distributed to those present copies of the Act and his September 17th memorandum to Moore, and he told them that his opinions were based on consultations with an attorney, for whom he provided an extensive list of credentials (JX 2 at 3; CX 27). Welch also told them that Cardinal's initial certification was flawed because it was submitted without his signature and omitted the information reflected in his September 17th memorandum to Moore. *Ibid.* Next, Welch quoted a section of the Act entitled "Criminal Penalties" stating that anyone who certifies an inaccurate statement "shall be fined not more than $1 million dollars or imprisoned not more than 10 years" and, if they do so willfully, "they can be fined not more than $5 million dollars or 20 years in prison" *Ibid.* Welch further stated that the word "willfully" meant "knowingly," and added that, according to his attorney, his August 14th email to Leon Moore constituted the CFO's certification regarding the accuracy of Cardinal's financial statements, but was excluded from the initial certification submitted to the SEC (JX 2 at 6).

Welch then proceeded to discuss with the meeting participants the third-quarter certification that was "coming up shortly" and his September 17th email to Moore. *Ibid.*

Regarding the two loan recoveries for $195,000, he stated that:

Over the course of the last six months, I brought this issue to the attention of senior officers and in particular to Leon, that recording those recoveries as income was not correct. According to the regulations of the FDIC, the FFIEC, and the IRS, everybody, says that loan recoveries are to go against the allowance account. And each time my opinion was disagreed with . . . . [H]owever, at year-end, Larrowe and Company heard the opinion and made changes. Uh, as a result of those entries, our net income for the third quarter last year was overstated by 13.7%. That is a material amount . . . [which] conceivably could impact the decision making of a potential investor . . . .

Ibid. He added that, consistent with the Act, as soon as such inaccuracies are brought to the attention of individuals who made these entries, whether done under the direction of superior officers or by mistake, those individuals become "guilty of fraudulent action because they have condoned it by silence by not doing anything about it" (JX 2 at 7; Tr. 148). He further stated that

Yesterday morning, [Moore] told me to restate the financial statements for the third and fourth quarter of last year the way I wanted them. But that . . . doesn't fix everything. The 10Q, the Call reports, the Y9 reports all have to be resubmitted for the third quarter, the fourth quarter of last year, first quarter, second quarter of this year, because that . . . seemingly little amount of [$195,000] impacted Retained Earnings, Liabilities and like Retained Earnings, the capital accounts roll forward from year-to-year.

Ibid.

Welch also addressed his refusal to certify the effectiveness of the internal controls, stating that:

My comment under this [paragraph five] is since Leon is the only person that reports to the Board, I have been instructed not to address the Audit Committee and he is the basically the only contact with Larrowe & Company, I can't certify that statement. Certification means that I swear that I did this, I evaluated, I designed and I reported. So I had, I could not address the Board, I could not address the Audit Committee nor the external auditors, nor have I done an evaluation . . . [of the] internal controls . . . .

Ibid.

Welch again reiterated his concerns regarding too many individuals making journal entries without the Finance Department reviewing or approving them (JX 2 at 7-8). He also stated that he had reported to Moore his concern with insider trading, that it constitutes "fraud," and that "a great deal of case law. . . [confirms that the] purchase date is what causes it to be insider trading," regardless of when the order is placed. *Ibid.* Welch then addressed the issue of "making credit entries to Sundry accounts on the liability side and debiting entries to Sundry expense at year-end." *Ibid.* He indicated that Annette Battle had made some inappropriate entries in Sundry accounts, and stated:

But what happened at year-end, items have been expensed . . . as Deferred Expenses and there's really no such thing as Deferred Expenses. There is Prepaid Expenses, but that's not the same. The first year I came here, there was like $18,000 worth of these. . . .

This year, I ran across $4,500 more. $4,500 was expensed at year-end and then in May those entries were reversed. . . . In May, when the travel expense, meal expense, officer expense, education expense, when those were reversed, it reduced those expenses which inflated net income which overstated the net income from what it really was. Now when you look at the track record of those having occurred at other times, there is a track record which indicates intent.

Ibid. Welch added that he had not checked every single entry and that "as any auditor will tell you, when they do a random sampling, usually you only see the tip of the iceberg" (JX 2 at 9).

Welch further brought to everyone's attention Section 806 of the Act entitled "Protection for Employees of Publicly Traded Companies Who Provide Evidence of Fraud." *Ibid.* He quoted this Section as stating that "no company or any officer, or employee . . . or agent of the company may discharge, demote, suspend, threaten or harass or in any other matter, discriminate against any employee in terms of condition of employ because of any lawful act done by the employee." *Ibid.* He added that "Federal law, in my opinion here today, supersedes the bank policy of not recording a meeting and I'll answer for that right or wrong." *Ibid.* Finally, Welch gave to those present a copy of Moore's September 13th response to his memorandum and stated that Moore made an ominous comment in this response when he stated "[y]ou must understand, these reports will be certified" (JX 2 at 10).

Welch testified that shortly after 5:00 p.m. that day, an employee of the bank delivered to his home address

a memorandum from Moore (copied to Densmore) instructing Welch to meet with Densmore on September 25th at 11:30 a.m. (Tr. 83; JX 3).[31] The memorandum stated that the meeting was intended to investigate Welch's allegations of fraud by Respondent's officers and employees and to address any other "serious matters" (JX 3). It also stated that because the meeting would involve "internal Company matters, you will not be permitted to have outside counsel present." *Ibid.*

Welch testified that he was unable to contact his then-attorney Terry Kilgore to discuss the proposed September 25th meeting until Monday, September 23, 2002 (Tr. 84).[32] After talking to Kilgore, Welch sent him a copy of Moore's memorandum and the recording of the meeting of September 20th (Tr. 84-85). Welch testified that he did not talk to Densmore between Monday and Wednesday, September 25th.

At 11:30 a.m. on September 25th, according to Welch, he went to Moore's office at the bank. When he arrived, he was surprised to find Cardinal's external auditor, Michael Larrowe, instead of Leon Moore (Tr. 87). Welch testified he believed that meeting with Larrowe would not be in his best interests because he was "part of the problem" and could not give an objective report of the meeting to Cardinal's directors (Tr. 87-88). Welch further testified that he had never met Densmore or Van Doren, the two attorneys representing Cardinal who were also present, and thus "didn't know what to expect" (Tr. 88). At that time, Welch informed Densmore that he had to talk to his attorney before meeting with Densmore and the others, and stated that there was a chance he would not be able to reach his

attorney until the next day as he was out of town. *Ibid.* Densmore replied that he and the others would remain in Moore's office waiting for Welch to meet with them, and that he would be billing Cardinal by the hour for their waiting time (Tr. 88; JX 8).

At 12:15 p.m. the same day, Welch received a memorandum (duplicated in an email) from Annette Battle informing him that his meeting with Densmore was rescheduled from 11:00 a.m. to 3:00 p.m. (Tr. 85; JX 4 and 5).[33] Welch testified that he replied to Battle at 12:45 p.m. via email and requested that the meeting be postponed until the next day so he could speak with his attorney (Tr. 86; JX 6). He wrote that he told Densmore earlier that morning that he had not had a chance to consult his attorney and that he would not meet with Moore and Densmore until he had done so (JX 6). Welch also wrote: "I want to stress this point I am not refusing to meet with Mr. Densmore. I simply must obtain legal advice on how to proceed. The last thing I want to do is phrase something in an inappropriate manner which could cause greater problems than now exist" (JX 6). He also wrote that he would be willing to "proceed to the next step," if his attorney so advised him the next day. *Ibid.* Finally, Welch asked to be provided before 2:00 p.m. the following day a copy of any policy adopted by Cardinal that precluded the presence of a personal lawyer at a meeting such as the one he had been ordered to attend. *Ibid.*[34] Welch sent another email to Battle at 3:14 p.m. reiterating that he would "not meet with Densmore and company until after I have met with my attorney tomorrow" (JX 8).

At 3:57 p.m. that day, even though he had previously explained the tape he had made during the September

20th meeting was in the possession of his attorney, Welch received a memorandum from Densmore requesting that Welch deliver the tape to him by 4:00 p.m. (JX 9) (Tr. 89). Welch reiterated in an email to Battle sent at 4:07 p.m. that he could not produce the tape as demanded by Densmore since it was in the possession of his attorney (JX 10).

At around 5:00 p.m. on September 25th, Welch received a letter signed by Venson Bolt, Chairman of the Audit Committee, informing him that he was suspended for refusing to meet with Cardinal's legal counsel and external auditor "on two scheduled occasions today" to assist the Audit Committee and the Board in its review of Welch's allegations of fraud (JX 11). Welch testified that he was never given an opportunity to meet with the Audit Committee, but was instead directed only to meet with Larrowe, Densmore, and Van Doren, none of whom were members of the Board of Directors or the Audit Committee (Tr. 90).

According to minutes of a joint meeting of the Audit Committees of Cardinal and Bank of Floyd which took place on September 25, 2002 at 4:09 p.m. in the Profit House Building,[35] the meeting was attended by Committee Chairman Bolt and Committee members Dr. Howard Conduff, William Gardner, Kevin Mitchell, and Dorsey Thompson (CX 34[36] at 1). Also in attendance were Leon Moore, Douglas Densmore, Jeff Van Doren, and Michael Larrowe. *Ibid.* The minutes reflect the following:

Leon Moore started the discussion by describing his meeting with Welch on September 17th and

September 20th (CX 34 at 1).[37] Next, Densmore and Van Doren assessed the legal implications of the situation. *Id.* at 1-3. In particular, Densmore stated it was Welch's responsibility to ensure that Cardinal had accurate financial records and reports, and appropriate internal controls. *Id.* at 5. He added that if Welch did not get a satisfactory response from Moore regarding his concerns, he should have brought them directly to the Committee's attention. *Ibid.* Instead, according to Densmore, Welch discussed them with other employees and failed to cooperate with the Committee's investigation initiated by Bolt. *Ibid.* Densmore added that Welch defied Moore's instructions to provide a tape of the September 20th meeting. *Id.* at 2.

The minutes further reflect that Densmore stated he and Larrowe met with Bolt on September 17th, and Bolt, in his capacity as Audit Committee Chairman, instructed Densmore and Larrowe to investigate Welch's allegations. *Ibid.* Van Doren reported that Welch was directed to meet with Densmore on September 25th so that his issues could be brought before the Audit Committee that same day. *Ibid.* He explained that Welch insisted on having his personal counsel present but was told that it would not be allowed due to the confidential nature of the information at issue. *Ibid.* Densmore briefly summarized Welch's allegations and concluded that Welch had so far refused to assist him and Larrowe in the investigation ordered by Bolt. *Id.* at 2-3. Densmore also noted that Welch had refused to sign a certification for Cardinal's Form 10-QSB for last quarter and informed Moore that he would not sign the next certification due in November 2002. *Id.* at 5.

Densmore concluded that "the Company had a CFO that had surfaced issues, but not in the proper way or in a timely fashion." *Ibid.* Densmore added that the Board needed to be concerned with the whistleblower provisions of Sarbanes-Oxley and "taking disciplinary action against Mr. Welch on account of his allegations. On the other hand, Mr. Welch's failure to handle this matter properly created substantial doubt about his viability as a CFO." *Ibid.* He then summarized potential legal claims that Welch could assert if he was terminated. *Ibid.*

The minutes of the September 25th meeting also reflect that Larrowe addressed Welch's allegations and offered his own counter-arguments. *Id.* at 3. He stated that the journal entries for $195,000 alleged by Welch to be improper were not credited to reserves because, had that been done, Cardinal would have been "over-reserved." He further stated that the manner in which these funds were recorded had no real effect on Respondent's reported results for the second and third quarters since they were reclassified and placed in reserves at year's end. *Ibid.*

Larrowe also repeated Densmore's comments that Welch refused to certify "10-Qs and 10-Ks" because he had not been involved in the design and implementation of disclosure controls and thus could not certify their effectiveness. *Id.* at 3. However, according to Larrowe, Welch never contacted Larrowe & Co. about this issue. *Id.* at 3-4. He further stated that it was the principal responsibility of the CFO to implement such controls to facilitate compliance with the Sarbanes-Oxley, and said "there was no evidence that Mr. Welch had begun this process or alerted anybody until now that he was not

doing it." *Id.* at 4. Larrowe also stated that, in his opinion, Cardinal's internal controls were in place and effective. *Id.* at 5. He also added that if Welch felt he was being prevented from developing internal controls, he should have reported it to the Audit Committee. *Id.* at 4-5.

According to Larrowe, if Welch believed his access to the Audit Committee was being restricted, it was "the number one reportable offense," which Welch should have reported directly to the Chairman of the Committee. *Id.* at 4. He stated that Bolt had indicated it was the policy of the Committee that the CFO could speak to its members or to Bolt at any time. *Ibid.* Larrowe noted that none of the Committee members suggested that Welch had ever complained before about restricted access. *Ibid.* He also stated that in performing the audits he had to "go through the [bank's] internal auditor," because Welch failed to provide the documentation he had requested. *Ibid.*

Larrowe also addressed Welch's purported request for authority to approve contracts. He stated that this request was properly denied because Welch was responsible only for reviewing contracts for mistakes, and making sure they were properly disclosed and recorded, not for approving such contracts. *Id.* at 3.[38]

With regard to Welch's allegation that too many individuals were making journal entries, and that this practice resulted in bookkeeping errors, Larrowe stated that Cardinal used a standard procedure for making journal entries which avoided excessive centralization and incorporated a "dual entry" safeguard. *Id.* at 4. He added that the finance

department should not review every entry made in Respondent's books but only the accounts, and that any problems with specific journal entries should be addressed only if the "reconciliation and proof" process at the end of the month uncovers any problems. *Ibid.*

Regarding Welch's allegations of fraud, Larrowe stated that he and legal counsel had approved Moore's stock purchase in September 2001. *Ibid.* He further stated any errors in the sundry accounts would be immaterial -- "a few thousand dollars at most." *Ibid.* Finally, Larrowe stated that, contrary to Welch's claim, the Board had properly approved a retroactive adjustment to Moore's compensation in the amount of $25,000 for 2001, and that appropriate entries were made at year's end to reflect it. *Id.* at 5.[39]

The minutes of the September 25th meeting also reflect comments made by Leon Moore with respect to Welch's conduct and allegations. The minutes reflect that, "after having reviewed Mr. Welch's work performance over the past two years, [Moore] had deep concerns about his ability to function as CFO." *Id.* at 6. Moore reported the following concerns to the Committee:

First, he cited Welch's "inability to control his temper." This, according to Moore, was evidenced by: Welch's outburst against local high school personnel when the Bank was using the school's computer lab for training; his confrontation with high school students who were using the Bank's parking lot for a fund-raiser (which prompted one parent to complain to Moore); and complaints made by the Bank's Financial Department

staff that Welch's behavior made them fear for their personal safety. *Ibid.*

Second, Moore denied Welch's allegations of insider trading. He stated that he had sought advice from both an outside auditor and legal counsel and received their approval prior to purchasing Respondent's stock in September 2001. *Ibid.*

Third, Moore stated that Welch failed to keep proper documentation for Cardinal's files on loan participations between Cardinal and Bank of Floyd. *Ibid.*

Fourth, he indicated that the state examiners have cited eighteen errors in the call report.

Fifth, he denied that the journal entries for $195,000 were improper, because "reserves for loan losses already exceeded the amount calculated as needed by the credit analyst," crediting reserve accounts would have resulted in over-funding of reserves, and any corrections can be properly made during the year-end review. *Ibid.*

Moore concluded his report to the Committee by stating that Welch had expressed concern for his job following the announcement of the pending affiliation with Mountain Bank Financial Corporation. *Id.* at 7. He stated that he assured Welch that, while there would not be a need for a "CFO," there would be other financial responsibilities and insurance-related activities which would offer new opportunities. *Ibid.*

After Moore concluded his report, Dr. Conduff inquired whether Welch had received a yearly

performance evaluation. Moore responded that no formal reviews were done on management but stated that he met with Welch approximately six months earlier to discuss the need for improving his performance (including the need to communicate more in person, rather than through memoranda). *Id.* at 6. He added that during this meeting, Welch became irate, raising his voice and pounding on the desk to the point that Moore's secretary had closed the door. *Ibid.*

Gardner then inquired whether the errors in the call report had been discussed with Welch. Moore responded that he was waiting to receive a written report prior to any such discussion, as was his standard practice. *Id.* at 6-7. Moore then departed the meeting, and Committee Chairman Venson Bolt asked the Committee members if Welch had ever approached them about his concerns, and all members gave a negative reply. *Id.* at 7.

At this point in the meeting, Densmore reiterated that Welch should have been "in immediate contact with the Audit Committee" to bring his concerns to their attention. *Ibid.* He concluded that there appeared to be "a total breakdown of Welch's ability to perform the functions of CFO" and that Cardinal could not continue in a dysfunctional relationship with its CFO. *Ibid.* Densmore stated that, nevertheless, it was important for the Committee to fully investigate Welch's concerns and report the results of its investigation to the Board. *Ibid.*

Dr. Conduff replied that he "would feel more comfortable to hear what Mr. Welch had to say before any action was taken." *Ibid.* In response, Van Doren

stated that the problem was Welch had refused to meet with Densmore and Larrowe, representing the Audit Committee, to discuss his concerns. He further stated that Welch had no right to have a third party attorney present during a discussion of internal bank matters, particularly since they would be sensitive and confidential and relate to publicly traded securities. *Ibid.* He added that he did not believe Welch would have a cause of action for wrongful termination under Virginia law should the Board terminate him. *Ibid.*

The minutes next reflect that, "[f]ollowing a period of extended discussion" (omitted from the minutes), Densmore made a recommendation that Welch be suspended indefinitely until further action by the Board. A motion to that effect was made by Gardner, seconded by Dr. Conduff, and was approved unanimously by the Committee. *Ibid.* Subsequently, Bolt again asked the committee members if Welch had contacted them, and no member indicated that he had. *Ibid.* Finally, the Committee asked Densmore and Larrowe to "complete their investigation of Welch's allegations and report them as soon as possible, hopefully with Mr. Welch's cooperation and assistance." *Id.* at 8.

Welch testified that, had he been given the opportunity, he would definitely have met with the Audit Committee, as opposed to its purported representatives Larrowe and Densmore, between September 25th and October 1st. He stated, however, he was never invited to do so (Tr. 90, 92-93). He also stated that he was willing to meet with the Committee without a personal attorney if Densmore and Larrowe were not in attendance (Tr. 93). He testified that

neither Bolt, nor any other member of the Audit Committee, ever sought a middle ground solution for the impasse that was created by Densmore's insistence that Welch not have a personal attorney present at the meeting (Tr. 92). In fact, he stated, Bolt never contacted Welch or his attorney during that time period (Tr. 93).

With respect to his unwillingness to meet Respondent or its representatives, Welch testified that Terry Kilgore, his attorney at the time, wrote a letter to Densmore dated September 30, 2002, in which he stated that Welch would make himself available to meet with the Committee that same day at 4:30 p.m. with Kilgore being present at the meeting (Tr. 94; JX 18). The letter stated that Welch felt he had been threatened, harassed and suspended by Respondent because of his lawful acts, and that he declined to sign documents certifying the quarterly reports because they contained untrue statements of material fact. *Ibid.* Welch testified that his suspension and the hostile tone of the September 25th meeting put him in apprehension that "if I went in without somebody . . . to speak on my behalf or to advise me, that anything I said or did was going to be taken out of context and used against me" (Tr. 95). He also believed that he was going to be fired for "waiv[ing] a red flag." *Ibid.*

Welch's testimony then turned to the allegations made by Moore, Larrowe, and Densmore that Welch's poor performance justified his termination. Welch acknowledged that Moore advised him during a meeting in May or June of 2002 that he wanted to communicate with Welch more in person rather than through memoranda (Tr. 99). Welch stated that he

could not recall whether he had raised his voice during that meeting but denied Moore's allegation that he pounded on Moore's desk. He stated that he had rheumatoid arthritis in his hands, one of his hands was in a brace at the time of the meeting following a recent surgery, and "pounding on anything is not a comfortable thing to do" (CX 31). *Ibid.* An email from Patricia Spangler dated April 15, 2002 to all bank personnel confirms Welch had undergone hand surgery around that time (CX 31 at 3).[40]

Welch also testified that Moore was incorrect when he stated during the September 25th Audit Committee meeting that the state examiners had identified eighteen errors in Welch's call report (Tr. 116). He noted that the number of errors identified by the examiners given to the Committee was three more than he had identified only a few days earlier at the September 17th Committee meeting without specifying what these additional errors were (*Ibid.*, CX 33 at 6).

Welch further testified that he had designed and implemented an Excel worksheet that allowed him to review the data for current wire transfers (Tr. 101).[41] He acknowledged that it was his responsibility to make sure that "tools were available for [his] employees . . . to track [this information]" (Tr. 106-07). He stated that Wanda Gardner, the Bank's internal auditor, conducted an audit and reported to the Board of Directors on July 24, 2002 that the process implemented by Welch did not allow for a timely retrieval of information (Tr. 100; CX 24 at 3).[42] Gardner's report was copied to the Audit Committee, Moore, Diane Ham (Vice President of Compliance Office), Betty Whitlock (Data Processing Manager), and Welch (Tr. 101; CX 24).Welch replied to

Gardner's report in a memorandum dated July 29, 2002 (copied to the same individuals), stating that Gardner's report was inaccurate, that he was not consulted during the audit, and that, as the CFO, "who is ultimately responsible for the Finance Department, hopefully, I will be asked for input on future audits" (Tr. 101; CX 24 at 1, 2). With regard to the wire transfers sent prior to the time he began recording these transactions in the Excel worksheet, Welch stated in his memorandum that he "assume[ed this information was] still available in the previous program" but he could not determine its availability since he was "not familiar with [the previously used] software" (CX 24 at 1).

Welch testified that, although he was not personally involved in retrieving wire transfer information, Gardner should not have relied solely on the input from Welch's subordinates who performed this function (Tr. 126-27; CX 24). Although he acknowledged that Gardner requested a response from him in her report to be submitted within fifteen days (CX 24 at 4), Welch insisted that Gardner should have discussed with him any questions regarding the effectiveness of this process prior to submitting her report since he was overseeing its ongoing development (which involved the loading of data for the old transfers) (Tr. 126-28). He added that, although Gardner was formally required to report to the Audit Committee and maintain independence from the bank officers as the internal auditor, she reported informally to Moore (Tr. 128).

According to Welch, Moore responded to his memorandum in a handwritten note stating: "Dave, your response should deal with issues in the audit and report it to Wanda. She will report the findings to the

Audit Committee" (Tr. 106). Gardner also replied to Welch's July 29th memorandum, in an August 20, 2002 memorandum to the Board of Directors, stating that Welch's reply indicated only that his worksheet allowed the wire transfers to be reviewed, not retrieved; that only 10 wires out of 13 could actually be retrieved; that Yara Middleton had reported that information could not be retrieved because "it was only keyed in for January 1-22, 2002" and she had not had any training at that time; and that Dianne Hamm reported the Excel worksheets could not be sorted by contents (CX 24 at 6). She also stated that keying in wire transfer information in 20 fields in the Excel worksheets, rather than just three utilized in the new software, created more room for errors and was more time consuming. *Ibid.* Finally, she stated that it was Welch's responsibility as the CFO to know where the information for the old wire transfers was and to make sure his department knew how to access it, since the finance department handled all such requests. *Id.* at 7. Welch testified that he understood Gardner's reply to mean that his Excel worksheets were "too efficient" (Tr. 107). He also explained that the data for the old wire transfers was recorded on old software installed on a computer that was no longer in use and was not readily accessible because "we had not recorded all that information yet." *Ibid.*

Welch testified that neither Gardner, nor Moore, had ever asked him to explain the capabilities of the Excel worksheets, and that he was never given an opportunity to present to the Board of Directors his side of the story regarding this issue (Tr. 105-06). He added that he was lead to believe he was not supposed to have access to the Board, but rather was required to

deal only with Moore (Tr. 108-09; CX 24 at 5). In support of this testimony, Welch cited Moore's aforementioned note and repeated statements made by Moore at staff meetings that all problems were to be brought to him, rather than to the Board, because "people need to remember who signs their paychecks" (Tr. 109).

When questioned about his qualifications on cross-examination, Welch acknowledged that prior to working for Cardinal, he had not worked for a financial institution and had no prior experience as a stock transfer agent (Tr. 128-29). He further testified that he had served on the Board of Directors of the Dan Luftke Hospitality House and the Sevier Terrace Recreation Organization in Kingsport, Tennessee, neither of which is a public company (Tr. 129). He stated, however, that he had some prior experience working for a public company (Arcata Graphics, Quebecor Printing, Thomas Nelson Publishers). *Ibid.*

Welch also testified that, although most of his complaints involved Leon Moore, he had never reported them to any of the members of the Board of Directors, other than Moore himself (Tr. 124). He explained he was trying to "work within the system and get Mr. Moore - persuade him to do what was right because it was right and not because other Board members or the Audit Committee put undue pressure on him. And I believe that to do otherwise would terminate my employment and my career in banking" (Tr. 125).[43]

With regard to his meeting on September 20th with Moore and the others, Welch testified that he prepared

a memorandum on September 13, 2002, after the CFO's conference, outlining issues that he intended to discuss with Moore (Tr. 144; RX 1). The memorandum noted that Welch believed Moore wanted to get rid of him and that he had made insinuations to others about Welch's integrity. *Ibid.* It also described two "options." The first option was to "[d]o nothing With a merger, elimination of positions are likely," which "might not be the wisest choice" because of the failure to comply with the Act with respect to the initial certification and the upcoming third quarter certification, as well as the protection afforded to whistle blowers by the Act. *Ibid.*[44] The second option consisted of eliminating Welch's position and repayment of the reminder of his bonus for 2001, full vesting of his retirement contributions, a letter of recommendation, and a "reasonable severance package - 6:00 GONE . . . . I will leave the bank quietly." *Ibid.*[45] Similarly, Welch prepared a general outline of topics to be covered with all the participants at the September 20th meetingwhich noted, in part, that over the past year, Moore appeared to be interested in getting rid of him (and cited some examples), and stated that their relationship had been damaged beyond repair (CX 26 at 3). It also stated that, on the advice of his attorney, Welch intended to offer the second "option" outlined above that would be "best for all parties," but which had to be done prior to the end of the current quarter because "[i]f I am here when the G/L is closed for the 3rd quarter and all issues have not been addressed and fixed, I must certify that the financials are not accurate nor are they fairly presented." *Ibid.*

Welch also testified that he met with an attorney on September 18th, 2002,[46] and started thinking about getting a severance package because:

[A]fter the CFO conference it occurred to me that something had to be done. I had to address it. I couldn't continue to dodge the issues and if the things that were broken . . . were not fixed then I would have to go elsewhere. And the only thing I wanted to do is if I'm going to have to go elsewhere and not be terminated, not have that void on my resume, that if I could get a severance package that would permit me to find another job then I would just walk away from it. I did not want to be fire (sic).

(Tr. 144-45).[47] Welch added that he intended to discuss with Moore not only his potential termination, but also the two certifications "and tell him . . . we could either fix the things that were broken or I would have to leave" (Tr. 143).

Welch acknowledged that he did not tape a portion of the September 20th meeting when only Marie Thomas and Fred Newhouse remained in the room,[48] but acknowledged that his outline reflected the issues that were discussed at that time, including Moore's efforts over the past year to build a case against Welch, and Welch's interest in pursuing his "exit options" (Tr. 150; JX 2 at 13).[49] He denied that he was willing to let Cardinal mislead its shareholders regarding his concerns if he was able to reach an agreement with the bank on a severance package, and stated that he simply "wouldn't say anything to anybody why . . . my position was eliminated . . . [and I would] just ride off into the sunset" (Tr. 153).

Kyle Venson Bolt

Bolt testified that he was currently "semi-retired" and previously worked as a farmer and a lumberman (Tr. 168). He had been a member of Cardinal's Board of Directors and the Audit Committee for many years, "ever since the beginning of Cardinal" in the mid-1990s (Tr. 168, 173).

Bolt testified that Welch was discharged on October 1, 2002 and that, to his knowledge, Leon Moore did not participate in that decision. *Ibid.* When asked why Welch was fired, Bolt testified: "[w]ell, I think the Committee thought he ought to come to us, I mean, and present his problem with us and he refused to do that" (Tr. 168-69). He learned about Welch's allegations from Moore sometime in mid-September 2002, but Welch never reported his concerns to Bolt or to other members of the Audit Committee (Tr. 169).

Bolt indicated that he was present at the Board of Directors and Audit Committee meetings on September 17 and 25, 2002 (JX 1; JX 12).[50] He testified that during the September 17th meeting Larrowe and Densmore were directed by the Audit Committee to investigate Welch's allegations and they later submitted a report describing the results of their investigation (Tr. 170-71; JX 20). The report, dated October 1, 2002, stated in part that the Audit Committee had met with its "professional advisors" Densmore and Larrowe on September 25th and again on October 1st to discuss allegations of financial irregularities made by Dave Welch (JX 20 at 3).[51] The report further stated that the Committee and its professional advisors had reviewed Welch's September

13th and 17th memoranda and the documents he distributed during the September 20th meeting, but that Welch made no effort to contact members of the Committee regarding his concerns and, "[d]espite being given several opportunities to meet with the Company's professional advisors, . . . has refused to meet with them unless he was permitted to have counsel present." *Ibid.* The report further stated that "we have the right to hear directly from the Company's [CFO] . . . without an outside attorney," and that Welch would not be allowed to dictate the process of investigation of confidential matters "by converting them into an adversarial proceeding." *Id.* at 4.

The report described the following results of the investigation of Welch's concerns:

First, with regard to the $195,000 recoveries, it stated that those transactions had been approved by Welch and were later corrected at the end of 2001 by the outside auditors. *Ibid.* Furthermore, according to the report, there would be no material impact on the bank's reported income because any increase in reserves for credit losses would have been balanced out by a charge to provision. *Ibid.* Nonetheless, the report stated that, based on a consultation with the outside auditors, the "reclassification in the third quarter 2001 numbers, though immaterial, will be made in the Company's third quarter 2002 10Q filing." *Id.* at 4-5. The report also admonished Welch for not reporting his concern to "our outside accounting firm" or to the Committee. *Id.* at 4.

Second, the report stated that Welch apparently demanded authority to approve Cardinal's contracts,

which was not part of the CFO's responsibility. *Id.* at 5. Rather, he had the responsibility to ensure that contracts were accurately recorded and disclosed, and to discuss any related concerns with the CEO. If his concerns were not satisfactorily addressed by the CEO, it was then Welch's responsibility to bring them to the attention of the Board and the Audit Committee which he "did not do." *Ibid.* Furthermore, Welch never identified any specific contract that he believed was not accurately recorded. *Ibid.*

Third, the report indicated that Welch had complained that he had not been permitted to review disclosure controls required under the Act (which had then been effective for only sixty days). *Id.* at 5, 7. The report noted that Welch's memoranda suggested he did not recognize his obligation to take the lead in the process of designing such controls, and that he had not communicated to the Board that he had been prevented from carrying it out. *Id.* at 5.The report stressed that disclosure controls had to be developed immediately but determined that Welch should not be involved. *Ibid.*

Fourth, the report addressed Welch's complaint that his access to the Audit Committee had been restricted. The report stated that Moore denied this allegation, and noted that if Welch truly believed Moore had restricted his access to the Committee, he had an obligation to report this to the Committee, which he never did. *Ibid.* The report also stated that the Committee had an open door policy with regard to the CFO. It went on to note, however, that the Committee would "not allow inappropriate restrictions to be placed upon it by any Company officer, including Mr. Welch, by demanding his personal lawyer be present." *Id.* at 6.

Fifth, the report addressed Welch's allegation that his access to the bank's outside auditors had been restricted, and concluded, based on an input from Larrowe & Co., that Welch played a "lesser role than he should [have], apparently by choice." *Ibid.* Again, the report noted that Welch failed to properly inform the Committee of any legitimate concerns of this nature in a timely fashion. *Ibid.*

Sixth, the report noted that if Welch's complaint regarding too many people making journal entries was indeed a serious matter, he should have proposed solutions to the CEO, and if still not satisfied, brought the matter directly to the Committee's attention. *Ibid.* The report further noted that Welch "made no effort to do so." *Ibid.* In addition, while the outside auditors approved of Cardinal's method of making journal entries, the report directed Moore to "consult with the [CFO] on this matter and to report to the Committee." *Ibid.*

Seventh, the report stated that Welch had made vague and unsubstantiated allegations of fraud by Cardinal's officers during the September 20th meeting. *Ibid.* It further stated that, as the CFO, Welch had an "absolute responsibility" to report incidents of this type to the CEO, and if unresolved by him, directly to the Board of Directors, or, in case of financial irregularities, the Audit Committee. *Id.* at 6, 7. However, he again failed to do so. *Id.* at 6-7. "In fact, when the Committee, through counsel, attempted to investigate these allegations, Mr. Welch refused to meet with counsel to facilitate such an investigation [in the absence of his attorney]." *Id.* at 7. The report added that Moore's stock purchases were cleared by the outside auditors and

counsel and followed Cardinal's procedures (since Cardinal had no established "black out period"). *Ibid.* In addition, the report noted that Welch tape recorded the September 20th meeting over Moore's objection, and later refused to provide the tape to the CEO and the Committee (and instead provided the tape to his attorney after he was directed to turn it over to the Committee). *Id.* at 3.

Eighth, the report dismissed Welch's concern with Sundry account entries, stating that they were immaterial and intended to better match income and expenses against the periods in which they were incurred. *Ibid.* Furthermore, the entries made the following year (reversing Sundry Credit entries) would have no impact on the financial statement reader since "these classifications are collapsed for external reporting and the amounts involved are insignificant." *Ibid.* Again, the report stated that if Welch's concerns were serious, he should have brought them to the Committee's attention, but "made no effort to do so." *Ibid.*

Finally, the report concluded that:

It is obvious from Mr. Welch's memoranda that a number of the critical responsibilities of a [CFO] of a public reporting company are not being adequately performed by him. Moreover, Mr. Welch has willfully refused to meet with this Committee or its professional advisors to discuss serious allegations he has made, unless he was permitted to have private counsel present. Despite having been repeatedly informed that he would <u>not</u> be permitted to have counsel present, Mr. Welch continued to insist on this point. Mr. Welch also

has refused directives to turn over his tape (or a copy of it) of a meeting with other Company employees where he presented his concerns to them.

It is apparent that Mr. Welch is unwilling or unable to function effectively as [CFO] of this Company and to fulfill his fiduciary obligations to the Company and its shareholders. Thus, we recommend that the Board of Directors terminate Mr. Welch's employment, effective immediately, and authorize the CEO to being (sic) searching for a replacement.

(JX 21 at 8).[52]

Bolt testified that, after reviewing the report prepared by Larrowe and Densmore, he was satisfied that Welch's concerns had been adequately addressed (Tr. 171).

According to Bolt, he also attended the October 1, 2002 meeting of the Audit Committee (JX 20).[53] The minutes of that meeting, reflect that it was also attended by Densmore, and by Committee members Howard Conduff, William Gardner, Kevin Mitchell, and Dorsey Thompson (JX 20 at 1).[54] During the meeting, Densmore described to the Committee the events that took place since the September 25th meeting.[55] In particular, he reported that Bolt directed Welch in a September 26th letter to meet with Densmore and Larrowe on September 30th without his attorney, but on that day he received a letter from Welch's attorney (Kilgore), who insisted on being present at the meeting. *Ibid.* The minutes further reflect that:

After consulting with Mr. Bolt, Mr. Densmore responded with a letter stating that Mr. Kilgore would not be allowed to be present and informing Mr. Kilgore that a failure by Mr. Welch to appear as directed by his employer would be considered willful refusal to perform his duties and that the Audit Committee would recommend appropriate disciplinary action to the Board of Directors, up to and including termination of employment as a result.

Ibid. Finally, the minutes also reflect that Larrowe went over the aforementioned investigation report. *Id.* at 1-2. He stated that Cardinal's procedures concerning review of contracts and journal entries "seem[ed] appropriate and in accordance with or better than those of other comparably sized community banks." *Id.* at 2. He also reiterated that Welch "should have insisted on addressing [his] concerns to the Audit Committees directly." *Ibid.* The Committee unanimously adopted the report[56] and concluded that Welch's "refusal to follow appropriate procedure in raising his concerns and the directives of th[e] Committee meant that he should be terminated." *Ibid.*

Later on October 1, 2002, after the meeting of the Audit Committee, Cardinal's Board of Directors also held a meeting attended by Leon Moore, Venson Bolt, Howard Conduff, William Gardner, C.W. Harman, Kevin Mitchell, and Dorsey Thompson (JX 21). The minutes of the meeting reflect that it started with Densmore describing the findings of the investigation reflected in the aforementioned report. *Id.* at 1. He concluded by stating that he was unable to substantiate Welch's allegations, and that "Mr. Welch appeared to be either unable or unwilling to fulfill his responsibilities

as the CFO," at which time the Board unanimously (with Moore abstaining) approved Welch's termination. *Id.* at 1-2. Next, Moore reported that the SEC had reviewed the entries for the 3rd quarter of 2001 and concluded that they were immaterial, but could be restated if Moore wished to do so. *Id.* at 2. Finally, Larrowe discussed issues related to Sarbanes-Oxley and suggested creating a binder for documents segregated by quarter to be reviewed by Moore and the new CFO in order to ensure compliance with the Act. *Ibid.* He also stated that he was going to host a conference on the Act, and Moore indicated that he intended to attend an ABA training session on the Act and invited others to do the same. *Ibid.*[57]

During cross-examination, Bolt testified that the Audit Committee met monthly and included, besides Bolt, Dr. Conduff, a dentist; William Gardner, "who is in charge of people attendance;" Kevin Mitchell, a dairy farmer; and Dorsey Thompson, also a farmer (Tr. 173-74). He testified that Moore attended most of these meetings (as the President and an administrative member of the Audit Committee), Wanda Gardner and Larrowe were often present, but Welch attended only one or two Audit Committee meetings (Tr. 176-77). Bolt testified that he was never shown Welch's August 14th memorandum to Moore (CX 20) or Welch's letter to Beth Worrell (CX 17) (Tr. 176-77). According to Bolt, Welch never attended any of the Board of Directors' meetings (Tr. 177).

Bolt also testified that when the Audit Committee met on September 17, 2002 to discuss Welch's concerns, Moore did not present any documents relating to Welch's performance as the CFO to the Committee (Tr.

178-79). Bolt was not sure whether he was ever shown any part of Welch's September 13th memorandum concerning the third quarter certification (CX 23), but he recalled that Moore showed him his response to the memorandum (CX 22) (Tr. 182).[58] Aside from Moore's memorandum, Bolt did not recall being shown any documents or "anything in writing" concerning Welch's allegations, other than the report of the investigation by Densmore and Larrowe (JX 20 at 3) (Tr. 182-83). Similarly, he did not recall the Audit Committee being shown any written materials during the period September 25th through October 1st (Tr. 183). Bolt added that, during that period, "there was some memos they might have wrote back and forth to each other" and [w]e had some correspondence in writing about actions being taken and letters being sent to Mr. Welch."

Bolt further testified that on October 1st, Douglas Densmore gave him a five-page memorandum containing purported findings of the Audit Committee (JX 20 at 3-7) (Tr. 183-84).[59] On cross-examination, Bolt was asked if he had ever seen any documents substantiating the conclusions stated in this report, but could not name any such documents (Tr. 184-85). He testified that although there had been only two Committee meetings on this subject (September 17th and 25th), he personally had additional discussions with Moore, Densmore and Larrowe regarding Welch's situation (Tr. 185). He further testified as follows:

Q You were totally dependent upon what Mr. Larrowe and Mr. Densmore and Mr. Moore gave you, isn't that right?

A I don't know whether you'd say totally dependent or not, we had faith in their work.

Q All right. You didn't go out on your own and do anything to find out whether Mr. Welch's allegations were correct did you?

A Well, that would have been useless for me to do, I think.

Q All right.

A I wouldn't be qualified to do that.

Q You, as the Chairman of the Audit Committee, bought six pages of opinion of Douglas Densmore and Michael Larrowe based on papers and documents that you never even saw, isn't that true?

A I don't know, I haven't read these documents fully. It'd take a while for me to thresh it all out. I don't know if I did or not.

(Tr. 184-85).

Bolt further acknowledged that Densmore and Larrowe were not on the Board of Directors, but were nevertheless engaged by the Committee to act as its representatives in the investigation of Welch's complaints (Tr. 186). He repeatedly testified he was never advised that part of Welch's complaint was that Larrowe's accounting firm (Larrowe & Co.) was giving bad advice to, or allowed improper practices to exist at, Cardinal (Tr. 187, 189-90).

Bolt acknowledged that Moore served as the President and Chairman of the Board, and was thus expected to report any significant developments at the bank to the Committee (Tr. 194). He testified that prior to September, 2002, Moore had never reported to the Committee that Welch had made complaints against him, but only that he, Moore, "had a little problem getting along with the staff. Was a little outspoken sometimes, things got pretty loud in the discussions he might have had with Mr. Welch in his office a time or two" (Tr. 195).

Bolt was also asked on cross-examination whether the Audit Committee had a rule prohibiting individuals who came before it from having their personal attorneys present (Tr. 191-92). Bolt replied that no such occasion had ever come up before (Tr. 192). He acknowledged, however, that the Audit Committee never adopted any resolution that would preclude Welch from bringing his attorney to a meeting with Densmore and Larrowe (Tr. 195). He further testified that the Committee "said - I think it was in agreement with the whole committee that we wanted to meet with Mr. Welch and hear his side of the story," but it never happened (Tr. 196-97). He stated that Welch was free to talk to the Committee, rather than with Densmore and Larrowe, because it had an open door policy, but Welch never requested such a meeting. *Ibid.* He acknowledged, however, that Welch was never invited to meet with the entire Audit Committee or told that he was free to meet with the Committee between September 25th and October 1st (Tr. 196).[99] He further testified that the Audit Committee was never told that Welch would come in front of it without his personal attorney, or that he only objected to appearing in front of Larrowe and

Densmore without his attorney (Tr. 198). Bolt also acknowledged that between Welch's suspension on September 25th and his termination on October 1st, the Committee never heard his side of the story (Tr. 196-97). Instead, the Committee knew only what it was told by Larrowe, Densmore and "a few employees in the bank" (Tr. 197).

Wanda M. Gardner

Gardner testified that she was Vice President of Cardinal and, since 1991, had held the position of Internal Auditor (Tr. 218, 226). When she joined the Audit Department in 1991, she was its only member and, at present, that department had only one other employee that worked eight hours per week (Tr. 226). Gardner assumed the Audit Committee made her the Internal Auditor on the recommendation of Leon Moore (Tr. 226, 242-43). She stated that she reported to the Audit Committee, felt free to go to it at anytime without an invitation, and believed that all senior executives had the responsibility of reporting any concerns with financial statements to the Committee on their own initiative (Tr. 227).

Gardner first met David Welch when he was an employee of Larrowe & Co. and knew that he was a CPA, but did not recall whether she knew about his Master's degree in Business Administration (Tr. 221). She acknowledged that she was not a CPA and had no accounting-related academic credentials other than courses in Accounting 101 and 102 which she completed at a Junior College (Tr. 227).

According to Gardner, the wire transfer audit she conducted disclosed that Cardinal's employees were unable to retrieve information in a timely manner, which she described as a "serious problem" (Tr. 219-20).[61] She did not believe it was necessary to talk to Welch about the pros and cons of his Excel spreadsheet before conducting the audit because it was a "routine" audit and she gave Welch fifteen days to respond to her report (Tr. 219, 229).[62] She testified that she followed standard audit procedures including gathering input from Yara Middleton and Patricia Spangler, the two bank employees who handled wire transfers (Tr. 218-19).[63] She also tried retrieving data from the Excel spreadsheet herself but was unsuccessful (Tr. 230). Gardner testified that she was concerned not because the spreadsheet contained too much information, but rather because "we only had to pull on three or four fields and there were like, I think, twenty fields in the spread sheet which, in my opinion was room for more error" (Tr. 230-31).

Gardner acknowledged that she had discussed her wire transfer audit with Moore prior to submitting her report to the Board of Directors and the Audit Committee, but not with Welch (Tr. 229-31).[64] She also acknowledged that whenever she had questions or concerns she discussed them with Moore, despite the fact that officially she reported to the Audit Committee rather than to Moore (Tr. 228). Gardner explained that, even though Moore was not an accountant, she reported her concerns to him, rather than directly to the Audit Committee, because Moore had been "in the business a whole lot longer than [she had]," and he was an administrative member of the Audit Committee (Tr. 228, 242).[65]

Gardner testified that she did not recall Welch ever discussing in her presence any concerns regarding the accuracy of Cardinal's financial statements (Tr. 221, 229).She further testified that she rarely talked to Welch, even though their offices were very close to each other, and she avoided raising her concerns about various issues with him (e.g., the efficiency of his Excel spreadsheets) because he had a "reputation for a short temper" throughout Cardinal (Tr. 238-39). According to Gardner, Welch had raised his voice to her on one occasion when they were discussing the bank's "participation lines" (Tr. 240). When asked if she liked Welch, she stated "[y]es, as far as I knew" (Tr. 239).

Gardner acknowledged she frequently attended Audit Committee meetings (albeit not all of them)[66] and could recall only one instance when Welch was present (Tr. 232).[67] She testified that she attended a special meeting of the Audit Committee on September 17th, during which she was shown Welch's September 13, 2002 memorandum (CX 23) and Moore's response to it (CX 22) (Tr. 222; CX 33). She did not believe that any allegations contained in Welch's memorandum related to wrongdoing by Michael Larrowe (Tr. 223). Gardner added that Venson Bolt had a tendency to forget things and could have forgotten that both these documents were shown during this meeting (Tr. 223).

Gardner also testified that she attended the September 20th meeting conducted by Welch and found nothing in his presentation that would cause her concern about the reliability of Cardinal's financial statements. *Ibid.* Instead, she understood Welch to say that there was someone who had committed fraud and that some improper entries had been made and later

corrected (Tr. 225). She knew at the time of the meeting that the Audit Committee had already started an investigation of Welch's concerns. *Ibid.* After the meeting, Gardner reported the substance of Welch's comments to Moore since he had left shortly after the meeting began, and Moore instructed her to convey this information to Densmore, whom she believed was representing the Board of Directors and the Audit Committee. *Ibid.*

Ronald Leon Moore

Moore testified that he was Chairman of the Board, President, and CEO of Cardinal, had been with the Bank of Floyd since 1988, and with Cardinal holding company since it was formed in 1996 (Tr. 245). In addition to his salary, Moore receives a monthly fee as a Director, and he was elected Chairman[68] of the Board in 2000 or 2001 by the Directors[69] (Tr. 265). He acknowledged that he wore three hats at Cardinal in that, as President of the bank, he reported to the Board; as a Director, he was responsible to the shareholders; and as Chairman of the Board, he had responsibilities to his fellow Directors (Tr. 266).

Moore testified that he originally hired Welch as a part-time accounting officer and, about a year later, promoted him to the position of CFO (Tr. 245-46). Moore also stated that he cooperated in the investigation of Welch's allegations regarding irregularities in Cardinal's financial statements and insider trading and did not participate in the decision to discharge Welch (Tr. 246). Moore testified that he consulted with Venson Bolt, made the decision to involve a legal counsel, and took part in a meeting on

September 17, 2002, at which "we . . . asked that an investigation be done" (Tr. 246). He added that he also provided any information requested by Michael Larrowe as part of the investigation (Tr. 246-67).

According to Moore, Welch signed a form that Cardinal filed with R.R. Donnelley Company approving the filing of "our King QSB report" for the third quarter of 2001 (Tr. 247; RX 6). Moore testified that by signing this form, Welch certified that the information provided by Cardinal was correct and that R.R. Donnelley was free to file Cardinal's financial information electronically. *Ibid.* Moore pointed out that Welch attached a note to this document dated November 20, 2001, which stated: "Leon, I have reviewed the 10Q and nothing came to my attention that required editing. As soon as you've had a chance to review and sign on the last page, I'll give RR Donnelley the OK to transmit to the SEC" (RX 6 at 2).

With regard to Welch's allegations of insider trading, Moore testified that he had not received Welch's October 6, 2001 memorandum on insider trading prior to the institution of this law suit, and added that it contained several inaccuracies (Tr. 262).[70] More stated he first contacted his broker in "January and February"[71] to inform him that Cardinal needed to sell some stock as quickly as possible and that he would buy any remaining shares only if other potential buyers did not (Tr. 249-50). He further stated that the "trade date"[72] for his purchase of 243 shares of Cardinal's stock was March 9, 2001, as reflected in a confirmation issued by Morgan Keegan (and a personal check issued by Moore in payment for the stock) (Tr. 249; RX 2 at 5, 1). According to Moore, the general public first learned of

Cardinal's intention to merge with Mountain Bank Financial Corporation from a press release issued on May 30, 2002 (Tr. 248; RX 3). He also testified that his decision to buy these shares pre-dated any discussions at

Cardinal regarding a stock split, which was first proposed at an executive committee meeting around April 19-20 and approved by the Board on April 25th (Tr. 250). He added that he followed Cardinal's procedure for approving stock transactions made close to the end of the quarter, which consisted of consulting legal counsel and accountants to make sure that there was no significant information unavailable to the general public (Tr. 250, 253). According to Moore, his purchase was cleared by Gene Derryberry, an attorney with the law firm of Gentry, Locke, Rakes & Moore in Roanoke, VA (Tr. 251). Moore also testified that the two entries totaling $195,000 were changed at year's end in 2001, consistent with Welch's recommendation, and those changes were released to the public both when the year-end report was filed (90 days after the end of the quarter) and when the annual report was issued around March 25-30, 2002 (Tr. 251). Moore added that the financial statements released in March, 2002 had no appreciable effect on the stock price, since the price range at the time they were released ($14.67 to $16.25 per share) closely resembled the price range at the time the third quarter financials were issued in September-August 2001 ($15.14 to $15.62 per share) (Tr. 252-53; CX 10).

Moore acknowledged that the day after Welch sent an email to Fred Doyle, the bank examiner, he made comments at a staff meeting about someone lying to the

bank examiners, but Moore further testified that he was not aware of Welch's email (Tr. 253-54, 276-77). He acknowledged that he did know Welch had discussed with Bob Bishop, a senior bank examiner,[73] some concerns related to the accuracy of call reports filed by Cardinal with the FDIC for the first quarter in March, 2002 and the year-end report for 2001 (Tr. 255, 276, 278-79). Moore believed Welch had made untruthful statements to the bank examiners because Bishop told him that Welch said he was out on sick leave when the call report was prepared and blamed multiple errors in the report on Cardinal's external auditors and malfunctions in the software that transfers information from the mainframe to the finance department (Tr. 254, 276-77). According to Moore, Welch had previously verified that he filed this report, and the bank examiners informed him that other banks were using the same software and that it was effective (Tr. 255-57). He further testified that the bank examiners concluded the errors were actually due to the lack of trained personnel in Cardinal's finance department (which forced Cardinal to rely on the information prepared by the accounting firm). *Ibid.* Finally, Moore denied making any statement during the staff meeting that employees needed to remember who signed their paychecks. According to Moore, that statement was actually made by Fred Newhouse (Tr. 258).

Moore further testified that he never had a plan to fire Welch, and reiterated he played no role in the decision to suspend or terminate him (Tr. 259, 280).[74] Initially, he was satisfied with Welch's performance as CFO, even though he "lacked experience in the banking area but as we got further into his employment with the bank it appeared that his performance

deteriorated." *Ibid.* Moore stated that he discussed Welch's performance problems with Welch and, as part of his plan for dealing with Welch's unsatisfactory performance, he offered Welch an opportunity to become the head of Cardinal's prospective insurance business (Tr. 259). [75] According to Moore, Welch accepted this offer, was excited about it, and "even told me several things that he would like to do when he headed that area up and we actually were proceeding on that basis." *Ibid.*

More denied that he ever told Welch not to communicate with Cardinal's directors or members of the Audit Committee. *Ibid.* He stated that it would be easy for Welch to contact these individuals because most of them "live within ten or fifteen miles of the bank. They're in the bank all the time. We're at certain social functions" (Tr. 259-60).[76] He added that Welch was a member of the Liability Committee along with William Gardner and C.W. Harmon, who were also members of the Board and the Audit Committee (Tr. 260).[77] Moore further testified that the note he made on Welch's response to Gardner's wire transfer audit report simply instructed Welch to respond to Gardner as she had requested, so that she could report the results of her audit to the Audit Committee (Tr. 261-62; CX 24 at 5).

Moore testified that he provided Welch's August 14th memorandum outlining his concerns to the Board of Directors on or about September 17th, approximately 30 days after he had received it (Tr. 267; CX 20). Moore also acknowledged that he had received and reviewed Welch's September 13th, 2002 memorandum discussing the applicability of the Sarbanes-Oxley Act to

Cardinal's quarterly certifications and offering comments and recommendations on this topic (Tr. 270-71, CX 23). He testified that he first saw Welch's August 2, 2002 letter to Beth Worrell, an accountant with Larrowe & Co., sometime prior to September 17th, and he understood it to say that Welch would not attest to the validity of Cardinal's financial statements because he had not been involved in their preparation (Tr. 271-73; CX 17). He also testified that his conversation with Bishop, the senior bank examiner, took place sometime after August 2, 2002 (Tr. 275). With regard to the September 20, 2002 meeting called by Welch, Moore testified that during the portion of the meeting that he attended, Welch did not discuss Sarbanes-Oxley, but rather accused Cardinal's employees of fraud and misconduct (Tr. 280; CX 25, 26 and 27).

Michael Larrowe

Larrowe testified that he was a CPA and a managing member of Larrowe & Co., a company that provides auditing services to approximately 30-35 community banks (all but three of these banks are public companies) (Tr. 284). He specialized in auditing community banks and has been doing this work for 23 years. *Ibid.* Neither Larrowe, nor his company had ever been the subject of any allegations of wrongdoing, nor have they been criticized by bank regulators or clients (Tr. 285-86). According to Larrowe, his company falls within approximately 15% of accounting firms that have never received any criticism as a result of peer reviews (Tr. 286).

Larrowe testified that David Welch had worked for his company starting in 1998, but that he did not personally recommend Welch for a position as a CFO of Cardinal (Tr. 287). Throughout Welch's tenure as the CFO, Larrowe & Co. provided auditing services to Cardinal. *Ibid.* Larrowe testified that he intermittently acted as the partner in charge of Cardinal's audits (based on the partner rotation policy), most recently in 2000. *Ibid.* In 2001, he acted as a concurring reviewer, and in 2002 he only provided technical advice to the engagement team and assisted in the investigation of Welch's complaint (Tr. 286-87).

Larrowe testified that on September 17, 2002, the Audit Committee of Cardinal asked him to assist in the investigation of allegations made by Welch. *Ibid.* According to Larrowe, prior to the September 25th meeting of the Audit Committee, copies of Welch's three memoranda dated August 14th, September 13th and September 17th were sent to the home addresses of each Committee member (Tr. 288, 293; CX 22, 23). Larrowe testified that he investigated the allegations found in Welch's memoranda of September 13th and 17th (Tr. 288). In particular, between September 17th and 25th, he looked through Larrowe & Co.'s audit files to determine the validity of Welch's concerns (Tr. 289).

Larrowe testified that three attempts were made to meet with Welch on September 25th prior to the Audit Committee meeting[78] (Tr. 289-90). On that day, Larrowe, Densmore and Jeff Van Doren[79] (another attorney from the Flippin, Densmore law firm), were expecting Welch in Leon Moore's office. *Ibid.* Larrowe testified that initially Welch had asked to defer the meeting in order to consult his attorney, but later

changed his position and refused to meet with Larrowe and others without his private attorney (Tr. 290). According to Larrowe, "Densmore, at that point, indicated that the proceeding was required by the Audit Committee, that it was not an adversarial proceeding and that it was not in connection with his employment. Consequently, having his private attorney would be inappropriate in those circumstances." *Ibid.* Larrowe testified that Welch never told him that he would meet with the Audit Committee without his attorney if he, Densmore and Van Doren were not present. *Ibid.* He testified that the following Monday, September 30th, the Audit Committee notified Welch that he was expected to meet with him and Densmore at 3:00 p.m. *Ibid.*

Larrowe testified that he was present during the entire meeting of the Audit Committee on September 25th (Tr. 291). During that meeting, the Audit Committee was notified that Welch had refused to meet with its representatives without his private attorney. *Ibid.* Also, Densmore and Larrowe reviewed Welch's concerns and their conclusions with the Audit Committee. *Ibid.* According to Larrowe:

The Audit Committee, after hearing the concerns and the results of the investigation, at that point asked or actually didn't ask, the Audit Committee, at that point, reaffirmed or affirmed that the investigation was of an internal nature, that it was not related to the employment of Mr. Welch and therefore his attorney's presence was not appropriate under the circumstances. They also indicated that his participation in the investigation was a requirement of his job in the normal course.

Further they expressed concerns about setting a president (sic) of allowing an employee to dictate similar conditions under which they would do their job and, considering all of the above, determined or decided to suspend Mr. Welch with pay at that point.

(Tr. 291-92). The Committee also instructed Larrowe and Densmore to make another attempt to meet with Welch, which they did on September 30th without success (Tr. 292). Larrowe added that he did not perceive any of Welch's allegations as being directed at him or at Larrowe & Co. *Ibid.*

He testified that he felt he was able to adequately investigate all of Welch's allegations, even though he never met with Welch in the process. *Ibid.* He concluded that "the bulk of [Welch's] concerns were without basis in fact and those that might have been technically correct were not relevant because they were not material to the financial statements" (Tr. 294). Even though he never met with Welch, he learned about his concerns from the following three sources: the memoranda of September 13th and 17th and interviews with individuals who were present during the September 20th meeting conducted by Welch, including Wanda Gardner and Leon Moore. *Ibid.* The investigators also asked the Board if any information had been supplied to them, but were told that Welch had never expressed any concerns to the Board. *Ibid.*

Larrowe testified that he and Densmore prepared an investigation report on behalf of the Audit Committee (Tr. 293; JX 20 at 3-8). He provided the following testimony regarding each of the nine findings itemized 1 through 9 in this report. He testified that the finding

marked as "Item 1" addressed Welch's allegation that $195,000 were improperly credited to income (Tr. 295-96). Larrowe acknowledged that "those were, in fact, recoveries which should have been credited to the reserve, the result of which was an overstatement of income" (Tr. 296). However, he added that this effect was "offset by an overstatement of provision [for loan losses][30] in the same periods, leaving no net income impact" (Tr. 296, 313; JX 20 at 4). Thus, according to Larrowe, these two entries at no point overstated Cardinal's income because they were simultaneously offset (Tr. 313-15). He denied that to a third party these entries would have looked like income, and noted that they did not appear as other income' but rather as a reduction of expense' and other expense' on the third quarter QSB Form (Tr. 314-15). He acknowledged, however, that when this entry "came to our attention" at the end of the year, "we . . . put it back in the reserve" (Tr. 316).

Larrowe further testified that Welch claimed that the CFO should have the authority to approve the bank's contracts, and that this claim was addressed under Item 2 of the report (JX 20 at 5). He testified that such authority could only be granted by Cardinal's Board (Tr. 296). He added that "[o]ur finings were that while authority to approve various contracts was not a part of that bank's control system, that the [CFO] did have the responsibility to review those contracts to be sure that they were recorded properly to the extent that they impacted the financial statements or the related disclosures" (Tr. 296-97).

Larrowe acknowledged, however, that the documents that he relied on in the course of the investigation

contained no indication that Welch was seeking authority to "approve" contracts (Tr. 316-20, 323-24; CX 23 at 4). He initially testified that this authority was part of a draft job description that Welch had prepared and submitted to Cardinal, and which Moore forwarded to Larrowe on September 13th along with a copy of Welch's September 13th memorandum (Tr. 316-17, 319; CX 23). However, later in his testimony Larrowe acknowledged that this document, in fact, contains the following language: "[a]udits contracts, orders and vouchers and prepares reports to substantiate individual transactions prior to settlement," which is "entirely different" than asking for authority to approve contracts (Tr. 317).[8] (As an alternative basis for his conclusion that Welch was seeking such authority, Larrowe cited a different copy of Welch's job description, but later acknowledged that this copy contained the exact same language quoted above (Tr. 323-24; CX 35). Larrowe finally acknowledged that Welch's job description "does not say that he will approve contracts entered into by the bank" and that he had simply "read it differently the initial time" (Tr. 324).

Larrowe denied, however, that Item 2 of the investigation report was without basis, and explained that Moore had indicated to him that Welch was seeking authority to approve contracts. *Ibid.* He acknowledged that Moore's assertion contradicted Welch's job description, but stated that he could not clarify this issue with Welch since he refused to participate in the investigation (Tr. 325).

Item 3 of the investigation report addressed Welch's complaint that he was not allowed to review the disclosure controls required by the Sarbanes-Oxley (JX

20 at 5).[82] Larrowe testified that these controls "were in the process of development and primarily the [CFO's] responsibility to design and implement," which Welch failed to do (Tr. 297; JX 20 at 5). He further testified that the responsibility for developing the financial and disclosure controls rested with each executive officer, including Welch and Moore, (since they were required to provide "Section 302 Certifications") as well as with the Board of Directors (Tr. 325-26; JX 21).[83] Larrowe testified that although Welch complained that he was not permitted to participate in this activity as required of him, he was simply trying to come up with an excuse for not performing this function and was actively avoiding being part of this process (Tr. 327-28). Larrowe explained that he arrived at this conclusion based on Welch's "resistance to participation in the investigation," his offer made in the September 13th memorandum to leave Cardinal quietly in exchange for a severance package and vesting in Cardinal's retirement plan, and "from several other things which we uncovered as a part of our investigation" (Tr. 328). He reiterated that he viewed Welch's offer to leave Cardinal as evidence that he did not want to participate in designing controls and added that "it seemed to me that he was trying to take advantage of the process." *Ibid.*

Larrowe noted that "we were working vigorously on preparing practice aides and helpful items for all of our clients at about that time, which were ultimately delivered around October 1st" (Tr. 350). He added that Welch never asked him for assistance in this regard, while Moore and Gardner had asked for help with Sarbanes-Oxley compliance and other clients' CFOs did so relentlessly (Tr. 350-51).

Larrowe added that, as noted in Item 4 of the report, Welch's complaint about restricted access to the Audit Committee was also dismissed, because Leon Moore and the Committee members denied it and, in fact, there was evidence that Welch had corresponded with the Committee in the past (JX 20 at 5, Item 4). He testified that he attended some of the meetings of Cardinal's Audit Committee, but did not recall ever seeing Welch at those meetings (Tr. 329). He added that Wanda Gardner attended most of these meetings. *Ibid.*

With regard to Item 5 of the report, Larrowe testified that Welch's allegation that his access to Larrowe & Co. had been restricted was also found to be groundless, since Leon Moore and the Audit Committee members indicated that they never directed Welch to refrain from contacting Larrowe & Co. (Tr. 298; JX 20 at 4). He added that "[f]rom our firm's standpoint, we are accessible to all of our clients . . . [and Welch's] previous employment with us gave him even more knowledge as to how to access us." *Ibid.* This conclusion was supported by "multiple pieces of correspondence" between Welch and members of Larrowe & Co. *Ibid.* Larrowe acknowledged that on or around August 2, 2002, Beth Worrell[84] showed him Welch's letter to her bearing the same date, in which Welch complained that Larrowe & Co. dealt exclusively with Moore and did not consult with him (Tr. 311, 337-38; CX 17). Larrowe acknowledged that the first person he called upon seeing this letter was, in fact, Moore, and that he also discussed it with Worrell and Wanda Gardner, but not with anyone else on the audit team (Tr. 312, 330, 338).[85] He testified that he did not call Welch to discuss his complaints because this letter did not contain any

allegations of wrongdoing, but mere complaints (Tr. 330).[86] He subsequently contradicted himself, however, stating he did not contact Welch because he believed that the letter did *not* contain any "complaints" (Tr. 334). Another reason he gave for not contacting Welch directly was because "it was apparent that he had . . . a relationship problem either with our firm or some concern about that or with the bank or with the process" (Tr. 331). He further explained:

We were, at that juncture, about three days into Sarbanes-Oxley. There were time pressures involved, everyone was working very hard trying to figure out what to do and what implications of the certification process were and basically we get this letter, which really doesn't say anything except, I don't get a chance to review journal entries on the front end. . . . I cannot respond affirmatively to all items included in the representations letter.

It did not say that he had any problem with any items in the representation letter only that he might have lack of knowledge with regard to some.

Then, of course, there's some discussion relative to contact with our firm or lack thereof. But, this letter is addressed directly to us.

I really didn't think that it bore discussion with him at that point because I thought he was picking a fight.

(Tr. 331-32). Larrowe testified that, at that time, he was not furnished with a copy of the representation letter that Welch attached to his letter to Worrell (CX 17 at 2-3).[87] He testified that Larrowe & Co. received a two-

page fax that contained only a cover page and the actual letter to Worrell without any attachments (Tr. 333).[88]

Larrowe testified that he had concluded the reason Welch could not certify the representation letter was simply because it covered the quarter during which he was out on sick leave for four to six weeks due to hand surgery (Tr. 332). He added that in the past, "[s]ometimes we got those [certifications] from Mr. Welch . . . and sometimes we got those from Mr. Moore," and that for audit purposes it was sufficient that the CEO had had made these representations (Tr. 332, 334).

With respect to Item 6, Larrowe testified that Welch's complaint about too many individuals making journal entries was also unfounded, since review of Cardinal's procedures and controls showed that they were of the commonly used type and better than those of many peer community banks (Tr. 299; JX 20 at 4). He added that it was the CFO's responsibility to "review . . . any journal entries for appropriateness," and that the investigation showed that Welch's ability to review those had not been restricted, and that entries were "appropriately approved on the front end, under dual control." *Ibid.* He noted that in a community bank, it is very common for people in other departments to make journal entries. *Ibid.*

With regard to Welch's allegation of insider trading, Larrowe testified that "we reviewed [stock trades] and found them . . . not to be problematic and not to constitute insider trading" (JX 20 at 4, Item 7).

Larrowe further testified that Item 8 of the investigation report dismissed Welch's concern involving sundry accounts ("one $4,500 and maybe another of $6,500") (Tr. 301; JX 20 at 5). He testified that after questioning several individuals, he and Densmore concluded that these accounts were "appropriately accrued at the end of those periods . . . [and] had been treated that way as long as I can recall." *Ibid.* He explained that if the same thing is done at the beginning and end of every year, the effect evens out. *Ibid.* He acknowledged that he was aware that any accounts payable (including sundry) should only be reversed by proper payment or when legally released by a creditor or by law. *Ibid.*[89] He testified that Cardinal's accounts were reversed by proper payment and denied having knowledge that no payments were in fact made (Tr. 335-36).

Larrowe further testified that Welch also questioned whether Cardinal's internal controls were sufficient to ensure the accuracy of its financial statements (JX 20 at 5, Item 9). He testified that, as Item 9 of the report notes, this complaint was found to be without merit "in light of the documentation control system contained in our audit files" and an interview with internal auditor (Tr. 301-02). Larrowe acknowledged that both the CFO and the CEO were responsible for conducting a comprehensive study of internal controls, as indicated on the Form 10-QSB certification (Tr. 336-37; *see, e.g.*, CX 23 at 2). He also added that Welch had previously signed representation letters, certifying, in essence, that there were no problems with internal controls and no fraud or irregularities by any member of management having a significant role in the internal control structure (Tr. 352-53; RX 5).[90]

Larrowe concluded his testimony regarding the investigation report by stating:

The Audit Committee, after hearing the results of the investigation[,] the conclusion of Mr. Densmore and myself concluded that Mr. Welch had not performed his duties, that he had willfully refused to meet with the committees . . . pursuant to its request and that he was repeatedly asked to do that and to not do that was inconsistent with his job responsibilities and that the tape of the September 20th meeting that Mr. Welch made pursuant to the objections of Mr. Moore, as I recall, had not yet been provided and the committee concluded, at that point, that he was unwilling or unable to perform his job effectively as the Chief Financial Officer.

The Audit Committee then recommended that the Board terminate Mr. Welch on that basis.

(Tr. 304-05; JX 21 at 8).

Larrowe testified that in the course of the investigation he also reviewed Welch's memorandum regarding journal entries in the amount of $23,868.71, but did not investigate them because Welch made no allegation of wrongdoing (CX 16). According to Larrowe, this memorandum simply reflected the fact that "Mr. Welch didn't understand the entries and did not post the entries correctly at December 31, 2001," as Larrowe & Co.'s subsequent investigation showed (Tr. 306). Larrowe added that the results of a historical accounting contained in a memorandum dated June 12, 2003 supported his conclusion (Tr. 309; RX 4).

Larrowe further testified that he is familiar with Cardinal's financial statements and added that they were approved by Welch (Tr. 309-10). In particular, Welch had signed "representations letter[s]" issued to the external auditor from Larrowe & Co., certifying that Cardinal has made all the required disclosures relevant to the financial statements, that all balance sheet items have been appropriately recorded or disclosed, that reserves are accurately stated, that there is no unasserted claims or assessments that were not properly recorded, that all the minutes of official meetings have been provided, that management recognizes its obligation for the accuracy of the financial statements and represents that they are fairly stated (Tr. 310; RX 5). It also contained a blanket representation that all the required disclosures were made and that the signor was not aware of anything "that the auditor did not ask for that they know would be relevant to the financial statements." *Ibid.* Welch had signed such representation letters on July 31, 2001, October 30, 2001, and April 24, 2002 (Tr. 311; RX 5). Thus, while Welch later complained about accounting issues, he had previously approved the resolution of those issues when the financial statements were being prepared (Tr. 311).

Larrowe acknowledged that on September 25th, Welch came down to Moore's office to ask Larrowe and Densmore to postpone the meeting until the next day so that his personal attorney could be present (Tr. 339). According to Larrowe,

[This request w]as denied by the Audit Committee because they view that as an investigation of an internal matter or their bank and it was not in

connection with his employment. It was not an adversarial proceeding to Mr. Welch whatsoever. All they wanted to know, he was a whistleblower, essentially, that wouldn't blow the whistle. All they wanted to know is what are your complaints. Tell us all you know so that we can investigate that.

(Tr. 339-40). According to Larrowe, prior to the Audit Committee meeting at 4:00 p.m. that day, three attempts were made to meet with Welch (Tr. 340).

Larrowe testified that during one of its meetings dealing with the investigation, the Audit Committee discussed at length whether it would be appropriate for Welch to have his attorney present during the September 25th meeting with Larrowe and Densmore and decided, by way of a formal action, that Welch would not be permitted to have his attorney present (Tr. 342; 345). However, the minutes of the Audit Committee meetings on September 17th and 25th, and on October 1st do not reflect such a formal action (CX 33 and 34, JX 20). He also testified that the Audit Committee had expressed this determination in a memorandum that was sent to Welch on September 20, 2002 (Tr. 340; JX 3). However, he then acknowledged that this memorandum was not authored by the Audit Committee or even by Densmore, but rather by Leon Moore (Tr. 341; JX 3).

Larrowe testified that between August 2nd and October 1st, he did not discuss with Welch his allegations outside of Densmore's presence (Tr. 346). He added that it was on September 17th or 13th that "we [learned] that he was making specific allegations

and that's the point at which we began to consult our audit file and the people that he had talked to" (Tr. 345).

On cross-examination, Larrowe was asked to explain the reasoning behind the decision not to allow Welch to have his personal attorney present (Tr. 346). He testified that it was due to the fact that "the investigation of the Audit Committee covered an internal investigation, it was not an adversarial action, with regard to Mr. Welch and it was not in regard to his employment status. The bank was trying to do the right thing and Mr. Densmore and myself, as appointees of the Audit Committee, we were trying to do the right thing" (Tr. 347). He further testified as follows:

Q Did you at any time seek any accommodation or any middle ground between your position and Mr. Welch's position?

A It wasn't my position to take, it was that of the Audit Committee and they did.

(Tr. 347).

III. SUMMARY OF THE PARTIES' ARGUMENTS

In his post-hearing brief, Complainant David Welch argues that he engaged in activity protected under the Sarbanes-Oxley whistleblower provision by repeatedly communicating to Respondent his concerns regarding Cardinal's financial statements and procedures (Complainant's Brief, "Comp. Br.," at 13-14). Complainant asserts that his allegations involved Respondent's conduct which he reasonably believed to

be prohibited under the Act. *Id.* at 14-19. Complainant further argues that he has carried his burden of proving by a preponderance of the evidence that his protected activities were a contributing factor in his discharge from Cardinal. *Id.* at 38-41. He also asserts that Respondent has failed to prove by clear and convincing evidence that he would have been discharged in the absence of the protected activities in which he engaged. *Ibid.* Specifically, he argues that Respondent has failed to present any evidence justifying its refusal to allow his personal attorney to attend his meeting with Larrowe and Densmore. *Id.* at 41. Instead, according to Complainant, this refusal constituted an effort by Densmore and Larrowe "sanctioned by Moore" to manipulate the investigation of his complaints and to create "an arbitrary barrier" to his appearance before Cardinal's Audit Committee. *Id.* at 27-37. With respect to the damages, Complainant seeks reinstatement without loss of seniority, back pay with interest, litigation costs, expert witness fees, and his reasonable attorney fees. *Id.* at 41. Complainant notes that no evidence relating to these potential damages was offered during the hearing, and requests that the parties be allowed to agree on the exact dollar amount. *Id.* at 42.

According to Respondent's post-hearing brief, Complainant was suspended and discharged solely for refusing to meet with the appointed representatives of Cardinal's Audit Committee without his personal attorney present (Respondent's Brief, "Resp. Br.," at 4-7). Respondent argues that Complainant was not entitled to have a private counsel present during this meeting and that the presence of Complainant's attorney would have "destroyed the confidential nature

of the communications and would have prevented the attorney-client privilege from attaching." *Id.* at 9-18. In addition, Respondent asserts that Complainant's claim that he needed an attorney because of intimidation "does not ring true." *Id.* at 18-19. Respondent further argues that Complainant's "whistle blowing" activities were not protected, because he could not reasonably believe that his allegations were true. *Id.* at 19-20, 27-33. Respondent also alleges that, even if Complainant's activities were protected, they did not lead to his discharge. *Id.* at 20-24. Finally, Respondent notes that even though Complainant's motivation for engaging in protected activity does not constitute an element of his claim, the evidence shows that he was simply using threats of prosecution under Sarbanes-Oxley as leverage in his effort to obtain a severance package and pursue employment elsewhere. *Id.* at 24-25.

IV. DISCUSSION

The whistleblower provision of Sarbanes-Oxley, set forth at 18 U.S.C. §1514A, states, in part:

No company with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l), or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)), or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee--

(1) to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by--

(A) a Federal regulatory or law enforcement agency;

(B) any Member of Congress or any committee of Congress; or

(C) a person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct) . . . .

18 U.S.C. § 1514A (a)(1); *see also* 29 C.F.R. § 1980.102 (a), (b)(1).

The whistleblower provision of Sarbanes-Oxley is similar to whistleblower provisions found in many other federal statutes.[21] Since the Sarbanes-Oxley Act is relatively new, reference to case authority interpreting other whistleblower statutes is appropriate.

When a whistleblower case proceeds to a formal hearing before an ALJ, a complainant must demonstrate by a preponderance of the evidence that protected behavior was a contributing factor in the unfavorable personnel action alleged in the complaint. *See Trimmer v. U.S. Dep't of Labor*, 174 F.3d 1098,

1101-02 (10th Cir. 1999); see also *Dysert v. Sec'y of Labor*, 105 F.3d 607, 609-10 (11th Cir. 1997). Once a complainant meets this burden, he is entitled to relief unless the respondent demonstrates by clear and convincing evidence that it would have taken the same unfavorable personnel action in the absence of any protected behavior. *Trimmer*, 174 F.3d at 1102.

Accordingly, in a Sarbanes-Oxley "whistleblower" case, Complainant must establish by a preponderance of the evidence that: (1) he engaged in protected activity as defined by the Act; (2) his employer was aware of the protected activity; (3) he suffered an adverse employment action, such as discharge; and (4) circumstances exist which are sufficient to raise an inference that the protected activity was likely a contributing factor in the unfavorable action. *See Macktal v. U. S. Dep't of Labor*, 171 F.3d 323, 327 (5th Cir. 1999); *Zinn v. Univ. of* Missouri, Case No. 1993-ERA-34 (Sec'y Jan. 18, 1996); *Overall v. Tennessee Valley Auth.*, Case No. 1997-ERA-53 at 12 (ARB Apr. 30, 2001). The foregoing creates an inference of unlawful discrimination. *Id.* With respect to the nexus requirement, proximity in time is sufficient to raise an inference of causation. *Id.*

In *Marano v. Dept't of Justice*, 2 F.3d 1137 (Fed. Cir. 1993), interpreting the Whistleblower Protection Act, 5 U.S.C. § 1221(e)(1), the Court observed:

The words "a contributing factor" . . . mean any factor which, alone or in connection with other factors, tends to affect in any way the outcome of the decision. This test is specifically intended to overrule existing case law, which requires a whistleblower to prove that his

protected conduct was a "significant," "motivating," "substantial," or "predominant" factor in a personnel action in order to overturn that action.

Marano, 2 F.3d at 1140 (citations omitted).

If Complainant fulfills this burden of proof, Respondent may avoid liability under Sarbanes-Oxley by producing sufficient evidence to clearly and convincingly demonstrate a legitimate purpose or motive for the adverse personnel action. *See Yule v. Burns Int'l Security Serv.*, Case No. 1993-ERA-12 (Sec'y May 24, 1995).Although there is no precise definition of "clear and convincing," the Secretary and the courts recognize that this evidentiary standard is a higher burden than a preponderance of the evidence and less than beyond a reasonable doubt. *See id.* at 4.

A. Whether Complainant engaged in activities protected by Sarbanes-Oxley?

"Protected activity," as defined under the Act and relevant regulations, includes, *inter alia*, providing (or causing to be provided) to an employer or to the Federal Government information regarding any conduct which the employee reasonably believes constitutes a violation of various fraud provision of Title 18 of the U.S. Code (§§ 1341, 1343, 1344, or 1348), any rule or regulation of the SEC, or any provision of Federal law relating to fraud against shareholders. 18 U.S.C. § 1514A (a)(1); *see also* 29 C.F.R. § 1980.102 (a), (b)(1). This statutory language makes it clear that Complainant is not required to show the reported conduct actually constituted a violation of the law, but only that he reasonably believed Respondent violated

one of the enumerated laws and regulations. *See id.* The standard for determining whether Complainant's belief is reasonable involves an objective assessment. *See, e.g., Minard v. Nerco Delamar Co.*, 92-SWD-1 (Sec'y Jan. 25, 1995), slip op. at 8.

Complainant alleges that he engaged in protected activity by:(1)submitting a memorandum dated August 2, 2002 to Beth Worrell, external auditor with Larrowe & Co.; (2) submitting a memorandum to Moore dated August 14, 2002, advising Moore that he could not certify the financial statements contained in the Form 10-QSB for the second quarter of 2002; (3) submitting a memorandum to Moore dated September 13, 2002, detailing some of the concerns raised in his earlier memorandum of August 14th; (4) sending an e-mail to Fred Doyle, a state bank examiner, asking for an opportunity to discuss his concerns regarding Cardinal's financial reports; (5) and by holding a meeting with Cardinal's senior personnel on September 20, 2002 concerning the applicability of Sarbanes-Oxley to Cardinal's financial practices (Comp. Br. at 13-14). In all these communications, Welch made one or more of the following allegations: (1) that two journal entries totaling $195,000 were improperly recorded with the effect of inflating Cardinal's reported income; (2) that his access to the outside auditors had been restricted; (3) that Cardinal's internal controls were inadequate since too many people without appropriate expertise were making journal entries; (4) that he was excluded from designing and evaluating Cardinal's disclosure controls; and (5) that his access to the Audit Committee had been restricted.

In its post-hearing brief, Respondent argues that Complainant's allegations are unsupported by a reasonable belief that violations were being committed because they were based on mere "assumptions and imagined facts that were not true" (Resp. Br. 19-20, 27-33).

For the reasons stated below, I find that at least three of the five allegations made by Welch were based on a reasonable belief that violations were being committed and that his activities associated with bringing these matters to light thus constituted "protected activity." This finding obviates the need to address whether or not the remaining two allegations also meet this definition.

(1) Welch's allegation that two journal entries totaling $195,000 were improperly recorded with the effect of inflating Cardinal's reported income.

In his September 13th memorandum to Leon Moore, Welch stated that one of the reasons for his refusal to sign Cardinal's third-quarter certification was Respondent's failure to correct two improper journal entries totaling $195,000 that appeared in Cardinal's financial statements for the third-quarter of 2001 (CX 23 at 1-5).[22] In this memorandum, Welch also indicated that, as a result of these entries, Cardinal's income for the third quarter of 2001 was overstated by 13.7% (CX 23 at 3; Tr. 49). Welch testified that although Larrowe & Co. eventually corrected these entries in Cardinal's year-end financial statements for 2001, they were never corrected in the financial statements for the third quarter of 2001 (Tr. 55-56). According to Welch, this was problematic because under the existing

requirements, "the third quarter's income statements and balance sheets [for 2001] would appear in . . . the third quarter of 2002 as comparative statements" relied upon by investors (Tr. 56, 71). Welch further testified that, because he considered the resulting increase in Cardinal's reported income to be material, he concluded that these entries constituted material false statements that did in fact mislead investors (Tr. 50-51).Furthermore, Welch testified that a sudden increase in the stock price between early September and late October, 2001 further convinced him that "these overstatements in income made Cardinal look like it was performing really better than it was," since he could not identify any other explanation for the increase (Tr. at 49). In fact, a stock transfer log prepared by Welch reflects a 21 percent increase in the price of stock after the third quarter report for 2001 from $13.00 per share on September 6, 2001 to $15.75 per share on October 18, 2001 (Tr. 50; CX 5).

Respondent argues that there was no reasonable basis for Welch's belief that the two recoveries totaling $195,000 were incorrectly recorded in Cardinal's books or that they caused an overstatement of Cardinal's income for the third quarter of 2001 (Resp. Br. at 27-28). Respondent points out that Welch had previously approved these journal entries and certified his approval to the external auditors by signing management representation letters (Tr. 70; JX 21 at 5; RX 5; Tr. 309-11). Furthermore, Michael Larrowe testified that although these entries did, in fact, overstate the income, any such effect was simultaneously "offset by an overstatement of provision [for loan losses] in the same periods, leaving no net income impact" (Tr. 296, 313-15; JX 20 at 4; JX 21 at 4;

Resp. Br. at 27). He denied that these entries would have looked like income to a third party, and noted that they did not appear as "other income" but rather as a reduction of "expense" and "other expense" on the third quarter QSB Form (Tr. 314-15). Finally, Respondent points out that Moore denied that there was an increase in the price of Cardinal's stock, and states that the price log prepared by Welch does not reflect the actual prices (Tr. 252-53).

I find Complainant's belief that the two entries were improper and could mislead potential investors was reasonable. Respondent's argument to the contrary is simply unconvincing (Resp. Br. at 19, 27). Welch testified that he believed the entries were improper based on the instructions for the preparation of a quarterly call report submitted to the Federal Reserve, which is similar to Form 10-QSB (Tr. 52). According to those instructions, any recoveries must go directly to the allowance account (which is a balance sheet account), and loan losses and recoveries can never go directly against income. *Ibid.*[23] Respondent never disputed this testimony. Furthermore, Respondent's own witness, Larrowe, acknowledged that "those were, in fact, recoveries which should have been credited to reserve, the result of which was an overstatement of income" (Tr. 296). Indeed, Welch testified that Beth Worrell, the auditor for Larrowe & Co., subsequently reclassified those entries in the year-end 2001 financials, after Welch brought them to her attention (Tr. 55). Larrowe corroborated this testimony when he acknowledged that once the entries "came to our attention" at the end of the year, "we . . . put it back in the reserve" (Tr. 316). Leon Moore similarly corroborated Welch's testimony that the two entries

were changed at year-end 2001, consistent with Welch's recommendation (Tr. 251). Thus, the fact that Respondent's external auditors corrected these entries consistent with Welch's recommendation is evidence that his concern was reasonable.

I also find that it was reasonable for Welch to believe that these entries were material and that Respondent had to restate them in its financial statements for the third quarter of 2001. Welch disputed Respondent's claim that the resulting income increase was offset by an expense increase, stating:

When the checks were received and deposited there was a debit to cash and a credit to the income accounts, either the other income or the other real estate income. Those were the only two entries. There were not any offsetting expense entries. It was a debit to cash and a credit to income.

(Tr. 359-60). His September 13, 2002 memorandum to Moore further explains:

In June and July of 2001, we received two recoveries on loans that had been written off quite some time before. When these monies were received they should have been . . . [booked to] the Valuation Reserve.

. . . .

As a result of these incorrect entries, Net Income, after income tax effect, was overstated by 13.7% for the third quarter of 2001 and 7.4% for the YTD September 30, 2001.

Net Loans were overstated by $195,000 (only 0.2%); Valuation Reserves were understated by $195,000 or 14.1%; Other Liabilities were overstated by $66,300 or 17.4%; and Retained Earnings were overstated by $128,700 or 4.5%.

Therefore, the Income Statement, Balance Sheet, and Cash Flow Statement for the third quarter of 2001 should be restated to accurately reflect the results of operations, financial condition, and cash flows (see attached sample Income Statements and Balance Sheet).

(CX 23 at 3) (underlining in original, bolding omitted). It seems entirely reasonable that, with entries totaling $195,000 recorded on the income side of the ledger in the manner described by Welch, and no corresponding entries on the expense side of the ledger, net income would be overstated. The third-quarter certification required Welch to ensure that Cardinal's quarterly report contained no "untrue statement of a material fact" and "fairly present[ed] in all material respects [its] financial condition" (CX 23 at 2). Welch could have reasonably believed he could not make the necessary certification because the entries in question resulted in a material misstatement of Cardinal's financial status.[24]

Larrowe testified that these entries would not look like income to a third party because they *did not appear* as "other income" but rather as a reduction of "expense" and "other expense" on the third quarter 2001 QSB Form (Tr. 316).[25] However, he gave contradictory testimony with respect whether these entries were recorded as income or not. For example, he testified initially that the entries were reported "[a]s a

component of other income" which represented part of the earnings of the bank for that quarter (Tr. 313). He similarly acknowledged that they "appear[ed] in two ways. It appears as an overstated item of income and an understated item of expense or vice versa." (Tr. 314). He also testified that "the result of [these entries] was an overstatement of income," even though he added that this effect was offset by another entry (Tr. 296, 313-15; JX 21 at 4; Resp. Br. at 27). During the September 25th Audit Committee meeting, Larrowe also acknowledged that these two items were recorded in 2001 as "other income" and "income from other real estate" (CX 24 at 3). He did not directly address Welch's assertion that the Income Statement, Balance Sheet, and Cash Flow Statement for the third quarter of 2001 had to be restated as a result of the entries to accurately reflect Cardinal's operations, financial condition, and cash flow (CX 23 at 3), nor did he contradict Welch's assertion that even after the changes were made by Beth Worrell potential investors would still be misled when comparing the third quarter income statement and balance sheet for 2001 to third quarter income statement and balance sheet for 2002 (Tr. 55-56). I am thus more persuaded by the testimony of Complainant with respect to the significance of these entries.

Furthermore, in his response to Welch's September 13th memorandum, Moore never stated that Welch's concerns were unreasonable, but rather asked for suggestions with regard to each allegation (CX 22). Also, contrary to Respondent's assertion (Resp. Br. at 27), Complainant's accounting expert never corroborated Respondent's claim that there was no effect on income and instead corroborated Welch's

opinion that these entries were improperly recorded (CX 30 at 2). Finally, Welch convincingly explained why he had previously signed financial statements and call reports without objecting to these two entries (RX 8; Tr. 69-72; 141-42). He noted that they were for regulatory authorities and not public documents that an investor would look at to make an investment decision, they did not have comparative financial statements, and he then believed he could persuade Moore to make the changes necessary to bring the financial statements into line with generally accepted accounting principles (Tr. 70-71). With respect to the 10-QSB's, he testified, in contrast, they contained comparative financial information, they were for public consumption, the Sarbanes-Oxley certifications contained a more rigorous standard, the Act provided for significant penalties for false certifications, and it promised to protect his employment in the event he raised concerns about improper conduct (Tr. 69-72).

(2) Complainant's allegation that his access to Respondent's external auditors was restricted.

In his August 2, 2002 letter to Beth Worrell, a CPA with Larrowe & Co. who supervised Cardinal's 2002 external audit, Welch stated that he could not attest to the validity of Cardinal's financials by signing a representation letter prepared by Larrowe & Co. because he did not have access to the necessary information. He stated that over the course of his tenure as Cardinal's CFO, "Larrowe & Co. has communicated primarily with Leon Moore on all issues" and "[o]ver the past year to year and a half, I have been excluded from your communications loop almost entirely," (CX 17; Tr. 358). He added that in light of the

recent enactment of Sarbanes-Oxley, he "need[ed] a better level of comfort before signing a representation [letter] such as yours." *Ibid.* Similarly, in his September 13th memorandum to Moore, Welch stated that "you [*i.e.*, Leon Moore] . . . have been the (practically) exclusive contact with Larrowe & Company . . ." and cited this exclusion from communications as grounds for his inability to certify the adequacy of Cardinal's third-quarter certification (CX 23 at 2; Tr. 57; 23 at 5).

Respondent asserts that this allegation was not reasonable. As evidence, Respondent cites the investigation report which concluded, based on a consultation with Larrowe & Co., that Welch "plays a lesser role than he should, apparently by choice" (JX 21 at 6). Respondent also notes that correspondence between Welch and various members of the auditing firm shows that his access was not restricted (Resp. Br. at 30; Tr. 298).

The evidence establishes that Complainant reasonably believed Larrowe & Co. did not sufficiently communicate with him regarding financial matters entrusted to him by his job description, but rather "went directly to Moore and around [Complainant]" (Comp. Br. at 16). Michael Larrowe's reaction to Welch's August 2nd letter to Worrell supports this allegation: Larrowe acknowledged that Moore was the first person he called upon seeing this letter and that he never contacted Welch to discuss his concerns (Tr. 330). The reasons cited by Larrowe for not contacting Welch are entirely unconvincing. He testified that, in his opinion, Welch's letter did not contain any allegations of wrongdoing, but mere "complaints," and that "it was apparent that [Welch] had . . . a relationship problem

either with our firm or some concern about that or with the bank or with the process" (Tr. 331, 334). However, Welch's concerns were unambiguously expressed and serious enough to prompt Larrowe to discuss them with Worrell, Moore and Gardner (Tr. 312). Larrowe also provided an alternative and inconsistent explanation, stating that he understood Welch's letter to mean that Welch simply lacked the necessary information because he was out on sick leave for several weeks during the relevant quarter (Tr. 332). However, Welch specifically stated in his letter that he had been "excluded" from such information "[o]ver the past year to year and a half" (CX 17). Finally, Larrowe testified that he did not inquire into Welch's concerns because it was sufficient for the purposes of the audit for Moore to sign the representation letter (Tr. 334). However, this testimony only illustrates Larrowe's willingness to bypass Welch, even in disregard of his explicit complaint.

Welch's allegation that Moore and Larrowe & Co. limited his input on important matters concerning Cardinal's financials is further supported by Michael Larrowe's approach to investigating Welch's complaints. In the course of this investigation, Larrowe (along with Densmore) relied heavily on Moore's representations without questioning their accuracy (CX 33; JX 21 at 5, Tr. 298). At the same time, (as I find below) they created what Complainant correctly terms "an arbitrary barrier" to his participation in the investigation (Comp. Br. 27).

I find this evidence to be more probative than the investigation report cited by Respondent, since the latter is a product of Larrowe's investigation of a

complaint directed at him and his company. In fact, Audit Committee Chairman Venson Bolt, who assigned Larrowe and Densmore to investigate Welch's complaints, testified that he was never advised that part of Welch's complaint was directed at Larrowe's accounting firm (Tr. 187, 189-90). As noted above, Larrowe's testimony that he did not perceive any of Welch's allegations as being directed at him or at Larrowe & Co. is unconvincing (Tr. 292). Furthermore, as with most other of Respondent's allegations, the report acknowledged the possibility that this violation did in fact occur and admonished Welch for not reporting it to the Audit Committee (CX 21 at 6).[26]

(3) Welch's allegation that Cardinal had inadequate internal controls because too many individuals outside of the finance department were making journal entries without the CFO's review or knowledge.

Welch repeatedly reported to Respondent his concern that Cardinal's internal controls were deficient because "[a]ll too often, journal entries (that should have prior review) are made by persons outside the Finance Department without the CFO's review or knowledge" (CX 17).[27]

As examples, Welch cited the two improper entries totaling $195,000 as well as entries to sundry accounts (CX 20, CX 23 at 2-3, 5-7).[28] In particular, he indicated that the entries for $195,000 "were made by someone not having the appropriate knowledge relating to generally accepted accounting principles, FFIEC guidelines or IRS regulations" (CX 23 at 3). Furthermore, in his September 13th memorandum to Moore, Welch also asserted that he was not given a

chance to review such journal entries, as required by his job description (CX 23 at 5-7; Tr. 61).

In its post-hearing brief, Respondent argues that this allegation was unreasonable because it was based on an unwarranted assumption that *all* journal entries should be made by members of the finance department and that in *all* journal entries had to be reviewed by the CFO (Resp. Br. at 32-33). However, the evidence shows that this statement misrepresents Welch's allegation and that Respondent was aware of the exact nature of Welch's complaint. The investigation report correctly formulated Welch's complaint as follows: "What Mr. Welch seems to suggest is that he desires to restrict the number of employees who can make journal entries to reduce the number of erroneous entries he is required to review and correct" (JX 20 at 6). Furthermore, Welch's September 13th memorandum specifically stated: "[o]f course routine entries . . . would not require review" (CX 23 at 6).

I find it was reasonable for Welch to believe that too many individuals without financial expertise were making journal entries without the CFO's review and that there were inadequate internal financial controls. The third-quarter certification required Welch to certify that he had disclosed "all significant deficiencies in the design and operation of internal controls" (CX 23 at 2). As Welch indicated in his memorandum, Cardinal's internal controls missed the two improper entries totaling $195,000 made by Wanda Gardner, which were ultimately reversed by Larrowe & Co. Furthermore, it was reasonable for Welch to attribute these improper entries to Gardner's lack of financial expertise since she was not a CPA and had only

completed two basic courses in accounting at a junior college (Tr. 227).

Similarly, Welch had reasons to question the propriety of making credit entries to "sundry credits" and then reversing them the following year, which had the effect of overstating Cardinal's income (JX 2 at 7-8). These entries were made by Annette Battle, Moore's personal secretary, who, based on the record before me, was not a CPA and had no accounting experience (CX 23 at 3; CX 20; CX 15; Tr. 227). Welch asserted that this practice was inconsistent with the GAAP which require "that income and expenses be matched against the period in which they are incurred" (Tr. 64-65). Respondent never denied this assertion. Welch further testified that this practice had "the appearance of manipulating income" or "pump[ing] up" earnings at mid-year, "which is a significant milestone for investors." *Ibid.* Welch added that this was "something that all the regulators strictly prohibit" and that under FASBE 140[22] sundry credits could only be reversed by proper payment (of expenses) or by judicial release (Tr. 65, 358-59). Instead, they were reversed when "around the middle of the following year, there were credit entries made to various expense accounts and debits made to the sundry credits account" (Tr. 359). According to Welch, this reversal was not appropriate because "it did not constitute payment nor did it constitute judicial release of the liability" (Tr. 359).Larrowe corroborated Welch's testimony regarding the requirements of FASBE 140 (Tr. 301). Although, Larrowe testified that these entries were reversed by proper payment (Tr. 335-36), he did not make this statement during his report to the Audit Committee on September 25th. Instead, at that time he

merelystated that any errors in the sundry accounts would be immaterial -- "a few thousand dollars at most" (CX 34 at 4). The investigation report also did not use this justification, but rather stated that these entries could not affect the financial statement reader because they "are collapsed for external reporting and the amounts are insignificant" (JX 20 at 7). Neither of these statements addressed Welch's claim that these entries, even if small, were part of a pattern that suggested that Cardinal's internal controls were deficient (JX 2 at 7-8).

It should be noted that Welch's complaint was well within the scope of his job description (CX 23 at 4).[100] Furthermore, Complainant's expert witness, Wynne Baker,[101] agreed with Complainant's assessment of the inadequacy of Cardinal's internal controls, stating:

In our practice of auditing banks, we have always found the issue [of too many employees making journal entries] to be a problem. We have asked our clients to limit the number of officers and employees who make journal entries. If the Board of Directors chooses not to limit the number of officers and employees who make entries, we ask them to either have all entries reviewed by an officer or have only certain officers making entries

(CX 30 at 2).

Finally, the investigation report prepared by Larrowe and Densmore directed Moore to consult with the CFO regarding the adequacy of internal controls and "to report [the results] to the Committee" (JX 20 at 6). The fact that, following what Respondent considered a "thorough investigation," the Audit Committee

directed Moore to further investigate this allegation is inconsistent with Respondent's assertion that the investigation had determined Welch's concerns were unreasonable. Similarly, the investigation report noted that "[i]f this is indeed a serious matter, we would have expected Mr. Welch to attempt to resolve it with the [CEO] by proposing workable solutions and if it remained a real concern to him from a financial reporting standpoint, to bring the matter to the Committee's attention directly." *Ibid.* The report admonished Welch for making "no effort to do so." *Ibid.* However, the record shows that Welch clearly made reasonable efforts to resolve the situation with Moore by providing workable solutions to the problem. The record further demonstrates that Welch reasonably believed he could not go directly to the Audit Committee, and instead attempted to bring these matters to light in such a manner that they would have to be addressed by Cardinal.

B. Whether Respondent, actually or constructively, knew of, or suspected, such activity?

Some or all of Respondent's top management were clearly aware of Welch's protected activities. It is undisputed that Respondent's CEO, Leon Moore, received Welch's memoranda dated August 14th and September 13th (Tr. 267, 270-71). Furthermore, Moore testified that he provided Welch's August 14th memorandum to Respondent's Board of Directors (Tr. 270-71). He also acknowledged that he had reviewed Welch's August 2, 2002 letter to Beth Worrell and understood it to say that Welch could not attest to the validity of Cardinal's financial statements because he had not been involved in their preparation (Tr. 271-73).

Moore also attended a portion of the September 20th meeting called by Welch (Tr. 280). In addition, Wanda Gardner, who was present during this entire meeting, testified that she reported the substance of Welch's comments to Moore since he had left shortly after the meeting began (Tr. 280; CX 25, 26 and 27). Furthermore, the minutes of the meetings on September 17th and September 25th and the investigation report leave no doubt that Respondent was fully aware of each one of Welch's allegations (as were Densmore and Michael Larrowe hired by Respondent to assist in the investigation of Welch's complaints) (CX 33, 34; JX 20).[102] I thus find that Respondent knew of Complainant's protected activities.

C. Whether Complainant suffered an unfavorable personnel action?

Sarbanes-Oxley provides that an employer may not "discharge, . . . suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment." 18 U.S.C. § 1514A (a)(1); *see also* 29 C.F.R. § 1980.102 (a), (b)(1). Complainant has alleged, and I find, that he suffered an unfavorable personnel action when he was suspended on September 25, 2002 and terminated on October 1, 2002.

D. Whether Complainant's activity was a contributing factor in the unfavorable personnel action?

For the reasons stated below, I find that Complainant has carried his burden of proving by a preponderance of the evidence that his conduct was a contributing factor

in his suspension and subsequent discharge. The evidence establishes that Respondent's "investigation" of Welch's complaints was orchestrated by Leon Moore, acting in concert with Larrowe and Densmore, in such a way that Respondent could justify Complainant's termination.

First, I note that proximity in time between Welch's protected activity and the adverse action is itself sufficient to create an inference of unlawful discrimination. *Macktal*, 171 F.3d at 327; *Zinn*, 1993-ERA-34; *Overall*, 1997-ERA-53 at 12. Welch wrote to Beth Worrell on August 2, 2002 stating that he could not sign the representation letter she had sent him for all the reasons cited above (CX 17). As Moore knew, he also wrote to Fred Doyle, a State bank examiner, expressing concerns about Cardinal's accounting procedures (CX 14; Tr. 156). On August 14, 2002, Welch wrote to Moore advising him he could not certify the financial statements in the Form 10 QSB for the second quarter of 2002 (CX 20). He again wrote to Moore on September 13, 2002, reiterating his concerns outlined in the preceding memorandum (CX 23). On September 20, 2002, he conducted a meeting with Moore, Wanda Gardner, and others to discuss the implications of Sarbanes-Oxley and the various concerns he had raised in his earlier memoranda (JX 2). The minutes of the joint meeting of the Cardinal and Bank of Floyd Audit Committees thereafter held on September 25th reflect that Welch was suspended that date in order to prevent him from having a "forum for further inappropriate internal meetings" (CX 34 at 7). Welch was subsequently fired on October 1, 2002. Thus, within a relatively brief period of time approximately six or seven weeks Welch had engaged in a number of

activities, all of which are close in proximity, and inferentially related, to Cardinal's decision to suspend and then terminate him.

Even without the inference of unlawful discrimination based on timing, Respondent's explanation of its actions does not ring true. Respondent argues that Welch was suspended and later discharged *solely* because he refused to meet with Larrowe & Densmore without a personal attorney (Resp. Br. at 1-19). Respondent repeatedly states that any adverse employment action was taken against Welch "[f]or this reason and this reason alone" (Resp. Br. at 2). However, the evidence adduced in this case shows that Complainant came under attack by Moore, Larrowe, and Densmore immediately after he refused to sign Cardinal's third-quarter certification and before he ever refused to meet with Larrowe and Densmore. First, Moore, Larrowe, and Densmore disparaged Complainant's performance before the Audit Committee to create a formal record of criticism directed at Complainant. Next, Moore, through Larrowe and Densmore, imposed an arbitrary requirement that Welch could not have his personal attorney present while being questioned about the various concerns he had raised about Cardinal's financial accounting practices. This requirement, as the sequence of events described below shows, was clearly imposed for the purpose of using Welch's anticipated refusal to comply as a pretext for firing him.

Moore's initial response to the September 13th memorandum outlining Welch's concerns was unreceptive and threatening. In his memorandum responding to Welch, Moore stated: "[y]ou must understand that these reports *will* be certified" (CX 22)

(emphasis added). Thereafter, on September 17, 2002, a "special meeting" of the Board was held (attended by Moore, Larrowe, William Gardner,[103] Bolt, and Densmore) with the official purpose of addressing the allegations raised by Welch in his September 13th memorandum (CX 33 at 1). Only Moore, Gardner, and Bolt were members of the Board of Directors, while the majority of directors[104] were not in attendance. Similarly, Bolt was the only member of the Audit Committee attending this meeting. Even before Welch's concerns were addressed, Moore offered a lengthy and detailed criticism of Welch's performance. He stated that Welch's allegations were unfounded and reflected his own failure to do his job and his deteriorating relationship with the company. *Ibid.* He also stated that Welch was "unwilling or unable to do what needs to be done to comply with the law" (CX 33 at 1). He then described purported problems with Welch's performance, which were unrelated to his allegations and which are unsupported by any documentation introduced by Respondent at the hearing. *Ibid.* Next, Densmore outlined Welch's complaints[105] and, without any transition, suggested, in essence, that Welch be terminated (CX 33 at 2). In particular, he stressed the need for an adequately performing CFO and noted that the Board had to either terminate Welch based on his inability to do his job, or remind him of his job responsibilities. *Ibid.* He warned, however, against taking the later approach and proceeded to discuss the potential ramifications of terminating Welch (CX 33 at 3).

Thus, Respondent had already taken significant steps during the September 17th Board meeting towards terminating Welch. Respondent concedes, and the

evidence shows, that Welch was not discharged for any of the alleged performance deficiencies. Indeed, Moore testified that he never planned to fire Welch and, in fact, offered him the opportunity to become the head of Cardinal's prospective insurance business (after the CFO's position was eliminated when Cardinal completed an impending merger with MountainBank Financial Corporation) (Tr. 259; CX 34 at 7). The events which transpired at the September 17th Board meeting establish that Welch became the subject of an adverse and discriminatory employment action well *before* he refused to meet with Densmore and Larrowe without his personal attorney (and even before any investigation into Welch's complaints had taken place). Thus, his subsequent "insubordination" was a mere pretext for his eventual termination.

The evidence also establishes that Moore, Larrowe, and Densmore manipulated the investigation and Respondent's Audit Committee. Larrowe and Densmore were assigned to investigate Welch's complaints by Venson Bolt, without informing him that one of Welch's complaints was directed at Larrowe and his company (Tr. 187, 189-90; CX 33 at 3). Bolt could not recall being shown "anything in writing"[106] concerning Welch's allegations, and the minutes of these meetings do not contain any attachments regarding Welch's written complaints[107] (Tr. 182-83, 183-84). He also acknowledged that he had to rely on Larrowe and Densmore because he was not qualified to investigate Welch's allegations (Tr. 184-85), which is understandable given the fact that he is a retired farmer and lumberman with no background in accounting or financial matters (Tr. 168).[108] At the same time,Densmore and Moore repeatedly impressed upon

the members of the Audit Committee that Welch's performance as a CFO was unsatisfactory and criticized Welch's performance in front of the Audit Committee during the September 25th meeting (CX 34). Moore engaged in a lengthy, itemized criticism of Welch's performance "over the past two years" (CX 34 at 6), while Densmore criticized Welch for failing to report his concerns "much sooner" directly to the Audit Committee "if he did not get a satisfactory response from Mr. Moore" (CX 34 at 5).[102] Densmore also stated that "the Company had a CFO that had surfaced issues, but not in the proper way or in a timely fashion" (CX 34 at 5). He concluded that Welch was unwilling or unable to do his job, that there was "a total breakdown of Welch's ability to perform the functions of CFO," and that Cardinal could not continue this dysfunctional relationship (CX 34 at 5, 7). Similarly, on October 1st, Larrowe and Densmore presented to the Committee and the Board their investigation report replete with criticisms of Welch's performance (*e.g.*, his failure to report his concerns directly to the Audit Committee) (JX 21 at 3-8). Thus, despite Respondent's (implied) claim that Welch was not terminated for his performance, Larrowe and Densmore sought to convince the Audit Committee that this alone was a substantial justification for terminating Welch.

In addition, the evidence shows that Moore and Densmore unilaterally imposed on Welch the requirement that he could have his own attorney present during their meeting. Contrary to Larrowe's assertion (Tr. 344-345), the minutes of the Board and Audit Committee meetings show that the Committee never adopted a formal resolution prohibiting Welch from having an attorney present during any meeting

with Densmore and Larrowe. (CX 33 and 34, JX 20). In fact, the first record indicating that Welch's personal attorney would not be permitted to attend any meeting with Larrowe and Densmore is a memorandum from Moore to Welch dated September 20, 2002 (JX 3). That memorandum states, in relevant part: "Please note that since this meeting involves internal Company matters, you will not be permitted to have outside counsel present at the meeting." *Ibid.* However, the minutes of the "special meeting" of the Board on September 17, 2002, before Moore wrote to Welch, reflect no such requirement. Similarly, the minutes from the September 25th meeting show only that Densmore informed Welch his personal attorney would not be allowed to meet with him and Van Doren at 11:30 a.m. that date (CX 34 at 2). When Welch showed up at Moore's office for the meeting:

Mr. Densmore told him that the purpose of the meeting was for Mr. Densmore and Mr. Larrowe, acting on behalf of the Audit Committee, to investigate and understand the issues that Mr. Welch had raised and to report the matter directly to the Audit Committee as directed by Mr. Bolt. Mr. Moore was not present. Mr. Welch stated that he would not participate in the meeting because his personal legal counsel could not meet at the time and he would not participate without legal counsel. Mr. Densmore informed Mr. Welch that the matters to be discussed were internal, confidential bank matters raised by Mr. Welch, that it was not a meeting to discuss his employment situation, and that outside legal counsel would not be permitted to attend. Mr. Welch requested time to speak with his attorney. Mr. Densmore directed that Mr. Welch meet with

himself, Mr. Van Doren and Mr. Larrowe at 1:00 p.m. Mr. Welch departed.

Ibid.[110]

Bolt testified that the Committee never adopted any resolution prohibiting Welch from having a personal attorney present at a meeting with Densmore and Larrowe (Tr. 195). Bolt further testified that the Committee members unanimously agreed that they wanted to meet with Welch and hear his side of the story, and the minutes reflect that Dr. Conduff, a Committee member, stated that "he would feel more comfortable to hear what Mr. Welch had to say before any action was taken" (Tr. 196-97; CX 34 at 7). Bolt testified that he believed Welch was free to talk to the Committee, rather than with Densmore and Larrowe, because it had an open door policy. *Ibid.* He also testified that the Audit Committee was never told that Welch was willing to come in front of it without his personal attorney, or that he only objected to appearing in front of Larrowe and Densmore without his attorney (Tr. 198). These and the other above-referenced facts preponderate in favor of a finding that Cardinal's suspension and termination of Welch resulted from his protected activity.

E. Whether Respondent has demonstrated by clear and convincing evidence that it would have taken the unfavorable personnel action irrespective of Complainant's having engaged in protected activity?

As stated above, Respondent argues that Welch was fired because he refused to meet with Audit Committee investigators without his personal attorney.

Respondent further argues that its insistence on this requirement was justified for two reasons:

> Concerned that the presence of Kilgore would destroy any privilege that might attach to this investigation, and to avoid converting the fact-finding investigation into an adversarial process oriented toward Welch's desire for severance,[11] Cardinal insisted that Welch appear without counsel. Not only did Welch *not* have the right to have his attorney present in the meeting, but Kilgore's presence would indeed have destroyed the confidentiality of the meeting and prevented the attorney-client privilege from attaching to communications at the meeting.

Resp. Br. at 9 (internal record citations omitted)(italics in original).

(1) Welch's right to counsel generally.

Respondent cites, in support of its argument that Complainant had no right to have an attorney present during the meeting with Larrowe and Densmore, "general employment law principles [establishing] Welch could have been discharged for even consulting with counsel on a matter related to his duties at Cardinal." *Id.* at 10. Although such principles may, indeed, provide a legitimate basis for terminating employees under certain circumstances, they have no application here. As explained above, the purpose of the meeting arranged by Moore and Densmore was not to conduct a legitimate inquiry into the various concerns raised by Welch regarding Respondent's accounting deficiencies and improprieties. Rather, it was their intent to create a situation whereby Welch would *not*

attend the meeting so they could use that act as a justification for terminating his employment.

(2) Welch's right to counsel under the circumstances presented by this case.

Nor can Respondent justify the exclusion of Welch's private attorney from the proposed meeting on the grounds that his attendance at the meeting "would have destroyed the confidential nature of the communications and would have prevented the attorney-client privilege from attaching." Resp. Br. at 11. Respondent had no reasonable expectation that the information to be discussed at the meeting was, under the circumstances presented here, confidential. The attorney-client privilege was thus inapplicable. Furthermore, even if the privilege applied, Welch, as an officer of Cardinal, could have waived its application.

a. "Confidentiality" of information to be discussed.

The sole purpose of the meeting, according to Respondent, was to elicit information *from Welch* about the circumstances surrounding events which he believed were unlawful, not to reveal to Welch information of which he was not already aware. This fact is made clear in a letter from Respondent's counsel to the OSHA investigator originally assigned to look into Welch's allegations. Counsel for Respondent wrote:

Since the meeting [between Welch, Densmore, and Larrowe] would have been solely for the purpose of obtaining information from Mr. Welch that may have been material to publicly traded securities, such matters could not have been discussed with anyone not

under a duty exclusively to the company to protect the confidentiality of the discussions for the benefit of the company. The presence of an attorney whose only obligation was to Mr. Welch personally would have made full disclosure of such matters problematic and, in fact, would have hindered the company's fact-finding efforts.

Feb. 4, 2003 Letter to Jack Rudzki from Laura Effel. Correspondence to Welch contemporaneous with the events giving rise to this litigation similarly substantiates that the purpose of the meeting was to gather information from Welch.[112] The meeting, had it taken place, could thus not have resulted in the disclosure of any information which was not already known to Welch.

Nor was there any legitimate risk that the information discussed at the meeting would be disclosed to others simply because Welch would have with him during the meeting an attorney representing his interests. Welch, as an officer of Cardinal, had a fiduciary duty to maintain the confidentiality of any proprietary information he learned in the performance of his duties. Any attorney retained by Welch under these circumstances would similarly be under a duty to maintain the confidentiality of any such information, whether learned from Welch directly or through discussions with Densmore and Larrowe while Welch was present. Indeed, Welch had already spoken to his attorney about these matters prior to the scheduled meeting and had given him the tape recording made during the September 20th meeting when many of these same issues were discussed. It is thus clear that,

had the meeting taken place, no disclosure of confidential information would have occurred.

Equally important to this issue is the fact that the information to be discussed at the meeting (*e.g.*, allegations of untrue or misleading statements of material fact regarding the company's financial condition, the absence of adequate internal controls, allegations of insider trading) is precisely the type of information which *must* be disclosed under Sarbanes-Oxley, either to the Federal government or the corporation's management. The fact that corporate employees are required to disclose such information hardly supports Respondent's assertion that it had a right to maintain the confidentiality of that information. In fact, Welch had already disclosed this information to the SEC on or about March 29, 2002, well before the proposed meeting in September 2002 (Tr. 137, CX 12, CX 13).

Furthermore, it is worth noting that the minutes of the September 17, 2002 special meeting of the Board expressly note that MountainBank Financial Corporation ("MFC"), a third-party entity with which Respondent was then attempting to merge, was to be apprized of the situation involving Welch's allegations (CX 33 at 3). The minutes of the September 25, 2002 Audit Committee meeting confirm that MFC had in fact been fully informed of the situation (CX 34 at 5). Respondent's disclosure of the substance of Welch's allegations to a third-party would itself constitute a waiver of the privilege if it applied in this situation. *See, e.g., United States v. Jones*, 696 F.2d 1069, 1072 (4th Cir. 1982) ("The proponent must establish not only that an attorney-client relationship existed, but also that the

particular communications at issue are privileged and the privilege has not been waived.").

Finally, in circumstances not wholly dissimilar to the situation presented here, one court noted that, "in determining the applicability of the attorney-client privilege . . . the court should consider whether an employer enjoyed an expectation of privacy with respect to a particular employee at the time the disclosure was made." *Amatuzio v. Gandalf Systems Corp.*, 932 F.Supp. 113, 118 (1996). One factor considered by the court in that case was the employer's knowledge that the employee "was potentially subject to an adverse employment decision." *Ibid.* In determining that the former employee's attorney should not be disqualified from litigation brought by the client against his former employer, the court held that:

[C]ommunications with a corporation's attorney made by, to, or in the presence of a non-attorney employee who later becomes adverse to the corporation are not protected by [state rules of professional responsibility governing attorney conduct] *or the attorney-client privilege* from disclosure by the former employee to his litigation counsel if (i) the litigation involves an allegation by the employee that the corporation breached a statutory or common law duty which it owed to the employee, (ii) the communication disclosed involves or relates to the subject matter of the litigation, and (iii) the employee was not responsible for managing the litigation or making the corporate decision which led to the litigation. We also see no reason why a similar rule would not apply with respect to disputes that have not yet resulted in litigation.

Ibid. (emphasis added).

In this case, Cardinal clearly knew, as evidenced by the discussions reflected in the minutes of the September 17th and September 25th meetings, that Welch was potentially an adversary in litigation against it involving allegations that Cardinal violated his rights under Sarbanes-Oxley by retaliating against him for engaging in protected activity. Furthermore, the communications which were to occur would clearly relate to the subject matter of any lawsuit brought by Welch under the Act. Finally, Welch played no part in making Cardinal's decision with respect to the circumstances which it knew could, and indeed did, lead to this litigation. The communications made by or to Densmore in Welch's presence would thus not be protected by the attorney-client privilege from disclosure to Welch's own attorney.

b. Waiver of attorney-client privilege.

As noted above, the burden is on the proponent of the attorney-client privilege to demonstrate its applicability, and to show "that the particular communications at issue are privileged and that the privilege was not waived." *United States v. Jones*, 696 F.2d at 1071. There is no question that the attorney-client privilege attaches to corporations as well as individuals. *Upjohn Co. v. United States*, 449 U.S. 383 (1981). However, as the Supreme Court has noted, application of the privilege in situations involving corporations presents special problems. *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 348 (1985). The Court wrote:

As an inanimate entity, a corporation must act through agents. A corporation cannot speak directly to its lawyers. Similarly, it cannot directly waive the privilege when disclosure is in its best interest. Each of these actions must necessarily be undertaken by individuals empowered to act on behalf of the corporation.

[F]or solvent corporations, the power to waive the corporate attorney-client privilege rests with the corporation's management and is normally exercised by its officers and directors. The managers, of course, must exercise the privilege in a manner consistent with their fiduciary duty to act in the best interests of the corporation and not of themselves as individuals.

Id. at 348-49.

Welch, as Cardinal's CFO, was a corporate officer of Respondent. As such, he had a fiduciary duty to Cardinal and its shareholders to ensure, *inter alia*, that Respondent complied with all applicable laws and regulations governing the administration of financial institutions such as Cardinal, and to disclose any failure of Cardinal to do so. In furtherance of those duties, he raised a number of issues regarding various events which occurred at Cardinal during the Summer and early Fall of 2002, which events he reasonably believed constituted violations of Federal law. Each of the issues raised by Welch concerned matters under the direct auspices of the CFO and involved a variety of documents and information to which he had legitimate access.

Clearly, the disclosure of perceived financial improprieties is in the best interests of a corporation's shareholders so they may ensure that the corporation's officers and directors are complying with, *inter alia*, their duties of due care, good faith, and loyalty. Furthermore, Sarbanes-Oxley was expressly enacted by Congress to foster the disclosure of corporate wrongdoing and to protect from retaliation those employees, officers, and directors who make such disclosures. When ordered by Moore to meet with Densmore and Larrowe to discuss the issues he had raised, Welch was clearly acting in furtherance of his fiduciary duty to disclose possible wrongdoing. Allowing him to have his own counsel present during the meeting would not only promote Welch's fulfillment of that duty, it would further the purposes of Sarbanes-Oxley by protecting Welch from retaliation for disclosing improprieties governed by the Act. As an officer of Cardinal, it thus was within his power to waive the attorney-client privilege consistent with his fiduciary duty to act in the best interests of Respondent. *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. at 348-49.

As noted previously, in light of the fact that Complainant has met his burden of proof, it is Respondent's burden to demonstrate by clear and convincing evidence that it would have fired Welch absent the above-described protected activity. *Yule v. Burns Int'l Security Serv.*, *supra*.That evidentiary standard is higher than a preponderance of the evidence and less than beyond a reasonable doubt. *Id.* at 4. For the reasons stated above, Respondent has failed to meet that burden, and Complainant is thus entitled to relief under the Act.

V. CONCLUSION

Whether Respondent actually violated, or intended to violate, any federal fraud statute or SEC rule or regulation is not, and never has been, at issue in this case. All that Sarbanes-Oxley requires is that the Complainant reasonably believed Respondent engaged in such conduct, he disclosed that conduct to the Federal government or his employer, and, as a result, he suffered an adverse employment action. 18 U.S.C. § 1514A(a)(1); 29 C.F.R. § 1980.102(b)(1). For all the reasons set forth above, Complainant has demonstrated by a preponderance of the evidence that he was fired by Respondent because he complied with his duty to disclose information governed by the Act. In its attempt to rebut that evidence, Respondent has relied exclusively on Complainant's refusal to attend a meeting with its outside counsel and external accountant as justification for terminating his employment. However, the rationale it has provided for demanding Welch attend that meeting without his attorney is simply not convincing. Respondent has thus failed to produce sufficient evidence to clearly and convincingly demonstrate that its motive for firing Welch was unrelated to his protected activity.

VI. REMEDIES

The Sarbanes-Oxley Act provides that any employee who prevails in an action under the whistleblower provision of the statute "shall be entitled to all relief necessary to make the employee whole." 18 U.S.C. § 1514A(c)(1). Relief under the Act includes reinstatement, back pay with interest, and compensation for any special damages sustained,

including litigation costs, expert witness fees, and reasonable attorney fees. 18 U.S.C. § 1514A(c)(2)(A)-(C). Similarly, the applicable regulation provides:

If the administrative law judge concludes that the party charged has violated the law, the order will provide all relief necessary to make the employee whole, including reinstatement of the complainant to that person's former position with the seniority status that the complainant would have had but for the discrimination, back pay with interest, and compensation for any special damages sustained as a result of the discrimination, including litigation costs, expert witness fees, and reasonable attorney's fees.

29 C.F.R. § 1980.109(b).

A. Reinstatement.

In his complaint in this matter, Welch seeks, *inter alia,* reinstatement with Cardinal without loss of seniority and benefits. Inasmuch as Complainant has established he was discriminated against by Cardinal because of his having engaged in protected activities, he is entitled to be reinstated to his former position as Cardinal's CFO without loss of seniority and without loss of any benefits to which he was entitled prior to his discharge.

B. Back Pay.

In his post-hearing brief, Complainant's counsel states: "Assuming arguendo that Welch is the prevailing party in this cause, respective counsel should be able to mutually resolve the details surrounding the

[relief authorized by the Act]. Absent passing upon what constitutes his reasonable attorney fees' there should be little need to call upon the Court's adjudicatory powers to resolve the precise amount of relief sought." Comp. Br. At 42.

The statute and applicable regulation expressly provide that a prevailing complainant is entitled to back pay with interest. Based on my determination that Respondent has violated the whistleblower provision of the Act, Complainant is therefore entitled to back pay with interest payable at the rate established by section 6621 of the Internal Revenue Code, 26 U.S.C. § 6621. Since no evidence with respect to Complainant's compensation was introduced during the formal hearing in this matter, the record will be held open for thirty days to allow Complainant to produce evidence upon which an award of back pay may be calculated. Respondent may respond to any evidentiary submission made by Complainant within fifteen days from the date upon which it receives Complainant's evidence. To the extent the parties believe that an evidentiary hearing is necessary with respect to the award of back pay, they should inform me of their desire for such a hearing immediately.

C. Special Damages.

As a prevailing party, Complainant is entitled to recover his litigation costs and expenses, including expert witness fees, and reasonable attorney's fees. An itemization of such costs and expenses, including supporting documentation, must be submitted by Complainant within thirty days from the date of this order. Respondent shall thereafter have fifteen days

within which to challenge payment of the costs and expenses sought by Complainant.

ORDER

IT IS HEREBY ORDERED that Respondent, Cardinal Bankshares Corporation:

1. Reinstate Complainant, in accordance with the conditions discussed above.

2. Purge Complainant's personnel file of all references to his engaging in protected activity and the discipline emanating therefrom, as discussed in the opinion above, and such references shall not be used against Complainant in the event he applies for any future employment opportunities with Respondent, or in providing a reference concerning Complainant to any other potential employers.

3. Pay to Complainant back pay and interest in an amount to be determined by supplemental decision and order based on the parties' submissions as described above.

4. Pay to Complainant all costs and expenses, including attorney fees, reasonably incurred by him in connection with this proceeding in an amount to be determined by supplemental decision and order based on the parties' submissions as described above. A service sheet showing that service has been made upon Respondent must accompany Complainant's application. The petition for services and costs must clearly state (1) counsel's hourly rate and supporting argument or documentation therefor, and (2) a clear

itemization of the complexity and type of services rendered.

STEPHEN L. PURCELL
Administrative Law Judge

Washington, D.C.

NOTICE OF APPEAL RIGHTS

This decision shall become the final order of the Secretary of Labor pursuant to 29 C.F.R. § 1980.109(c) and § 1980.110(a) unless a petition for review is timely field with the Administrative Review Board ("Board"), U.S. Department of Labor, Room S-4309, 200 Constitution Avenue, NW, Washington, D.C. 20210. Any party desiring to seek review, including judicial review, of a decision of the administrative law judge must file a written petition for review with the Board, which has been delegated the authority to act for the Secretary and issue final decisions under 29 C.F.R. Part 1980. To be effective, a petition must be filed with the Board within 10 days of the date of the decision of the Administrative Law judge and specifically identify the findings, conclusions or orders to which exception is taken. Any exception not specifically urged ordinarily will be deemed to have been waived by the parties. If a timely petition for review is filed, the decision of the administrative law judge will become the final order of the Secretary unless the Board, within 30 days of the filing of the petition, issues an order notifying the parties that the case has been accepted for review. If a case is accepted for review, the decision of the administrative law judge will be inoperative unless and until the Board issues an order adopting the decision,

except that a preliminary order of reinstatement will be effective while review is conducted by the Board. The Board will specify the terms under which any briefs are to be filed. Copies of the petition for review and all briefs must be served on all parties and on the Chief Administrative Law Judge at the time it is filed with the Board. Copies of the petition for review and all briefs must also be served on the Assistant Secretary, Occupational Safety and Health Administration, and on the Associate Solicitor, Division of Fair Labor Standards, U.S. Department of Labor, Washington, DC 20210. *See* 29 C.F.R. § 1980.109(c) and § 1980.110.

[ENDNOTES]

[1] As noted below, Cardinal Bankshares is a parent holding company of the Bank of Floyd. However, because the distinction between these two entities is largely immaterial for the purposes of this decision, the two entities will be referred to collectively as "Cardinal," except on those few occasions when such distinction becomes significant.

[2] In this memorandum, Welch also stated that Moore and Gardner had misinterpreted Cardinal's participation agreement which stated that the service charge would be ".25% of Interest Earned by Participant hereunder" to mean .25% of the interest rate charged rather than the interest actually earned, which Welch maintained was the correct interpretation. *Ibid.* He also asked to be consulted whenever a decision was made to change any of his entries. *Ibid.* He further added he told Moore in his memorandum that when Moore hired him, "[y]ou told me . . . you did not want a "Yes man" and I have found it impossible to be one.

While we are not an Enron Corporation, we have some similarities. Their management did not listen to their accounting employees either. I keep hoping this will change" (CX 1).

[3] In this memorandum, Welch also quoted a number of court cases which define insider trading and concluded that "none of the definitions and none of the court cases mention final' numbers as you referred to the FR Y-9C numbers yesterday. All refer to material nonpublic information.' This would include internally generated financial statements such as the board reports or projections based on internally generated reports" (CX 6 at 2). He also stressed that Fred Newhouse did not make any offer or bid, but simply agreed to the seller's price, "which was based on what the internet showed as the latest trade price." *Ibid.*

[4] Welch explained that the April 19th date actually relates to the issuance of the stock certificate by the Morgan Keegan Company to Moore. *Ibid.*

[5] Welch noted, however, that no more trades in Moore's name went through him, although he was responsible as transfer agent for the cancellation of the old stock certificates and the issuance of the new stock certificates. *Ibid.* He added that he had previously told Moore that he could not monitor trades if stocks were traded in "street name" only, rather than through Welch as Cardinal's transfer agent (Tr. 40). Welch explained that by "trade in street name" he meant trade accomplished through stock brokers in stock held in the name "CEDE and Company" by the Depository Trust Company in New York (Tr. 40-41).

[6] He acknowledged that, as the CFO, he was responsible for ensuring that any shareholder who reached the ten percent ownership threshold filed a report with the SEC, with the exception of stock owed in street name, since he could not determine its ownership (Tr. 134-35). He testified that he had no knowledge as to what percentage of J.P. Morgan Chase stock is held in a street name (Tr. 135).

[7] This document was not offered in an email format (CX 12). Although the document makes it clear that it was authored by Cardinal's CFO, it does not contain Welch's name or signature. *Ibid.* Also, for unexplained reasons, the document starts with the name, title and contact information for Leon Moore. *Ibid.* Welch also offered into evidence what appears to be a form letter from the SEC, which was apparently transmitted over the Internet, confirming the receipt of a complaint and thanking Welch for reporting his concerns (CX 13).

[8] Welch also testified that, after his discharge on October 1, 2002, he met with a representative of the Federal Bureau of Investigation, the Assistant Attorney General of the State of Virginia and, by telephone conference, with the Atlantic Region Counsel for the SEC in Abingdon, Virginia (Tr. 123-24).

[9] Welch's email to Doyle stated, in part:

You may have gathered from my "hypothetical" questions today . . . that I was leading somewhere. . . . Unfortunately, Bon's [sic Leon?] entrance kept the conversation from being completed.

If my being your source of this information becomes known, I will be fired by Leon before the sun sets. So, please review the info I'm going to give you and if you think there is anything to it, you can just "stumble across" some odd looking journal entries on your own and be a hero. . . .

I have fretted long enough about some of the things that have gone on at the bank that I do not think are on the up and up. I just have to let someone know. It drives me mad when I think someone is being dishonest and my conscience won't rest until I speak up.

Hopefully, I am just being paranoid, but I'm afraid that is not the case.

If you go into my office and get the Board Reports binder for 2002, there is a folded set of T accounts in the flap on the inside front cover for your review.

(CX 14). Doyle did not meet with Welch in response to this email.

[10] The Act required that this certification be filed no later than August 14, 2002. *Ibid.*

[11] Hereinafter, the underlined language corresponds to those portions of the two certifications that Welch underlined and highlighted with bold type in his memorandum (CX 23 at 2, 8).

[12] Welch testified that prior to the September 13th memorandum, he had written another memorandum to Moore explaining his refusal to sign this certification and that he wrote the September 13th memorandum

pursuant to Moore's request for a more detailed explanation (Tr. 45; CX 23 at 3-7). Welch stated that his original memorandum contained page 2 of CX 23, while the September 13th memorandum contained page 2 as well as pages 3-7 of CX 23, which further detailed Welch's comments found on page 2 (Tr. 45-46).

[13]During his direct examination, Welch further explained that in June, 2001 (second quarter), residual payments on lease assignments in the amount of $45,000 were recorded as "Other Income" and in July, 2001 (third quarter), a $150,000 settlement received from a "Sully Tech" judgment on a charged off loan was improperly recorded as "Income From Other Real Estate" (Tr. 55, 315-16; JX 1, 12).According to Welch, Moore told him that these entries were recoveries for losses that had been previously written off (Tr. 54). Welch testified that he believed the entries were improper based on the Federal Reserve's instructions for the preparation of a quarterly call report submitted to the Federal Reserve, which is similar to Form 10-QSB (Tr. 52). According to these instructions, any recoveries must go directly to the allowance account (which is a balance sheet account), and loan losses and recoveries can never go directly against income. *Ibid.* Welch explained that "some people would argue that if a recovery like this had been taken to the . . . balance sheet account, then the expense account could have been reduced accordingly . . . . In other words, at September 30th we could have reduced the expense put into that account through October, November, December, but the federal call reports prohibit you [from] going back and [reducing the expenses to offset a recovery that was put in the allowance account]. Once those entries are made July, August and September

you can't just reverse those, you have to reduce future expenses to offset that. So, at this point in time the financials were inaccurate" (Tr. 52-53).

[14] Welch acknowledged that the bank's management, not the auditors, were responsible for preparing financial statements and periodic SEC filings (Tr. 129).

[15] Welch indicated that this conference was organized by the Virginia Bankers Association (Tr. 74, 95-96).

[16] Welch stated that at that time he had not yet attended the September CFOs' conference and knew about the Act only from reading "whatever material [he] could find" *Ibid.*

[17] The memorandum stated that Welch had discussed this problem with Welch and Larrowe & Co. "on several occasions over the past three and one half years" (CX 23 at 5).

[18] "Dual control" means that two signatures are required for each entry (Tr. 61).

[19] In particular, Welch stated that Annette Battle, Moore's secretary, credited $4,500 to sundry credits, and made other similar entries that were approved by Moore, including a number of debits made to expense accounts such as officer expenses, transportation and education (Tr. 64; CX 15). According to Welch, Moore had told him that when year-end earnings exceed target earnings, "[y]ou have the opportunity to set aside some money to cover expenses in the following year." *Ibid.* Welch testified that such entries decreased income for the year when they were made, but had a

major effect on the financials for the next year since they artificially inflated mid-year earnings for the next year by understating the expenses (Tr. 64-65).

[20] Financial Accounting Statement Standard No. 140 (Tr. 335).

[21] Welch explained that the call reports are reviewed by the Federal Reserve with copies going to the Virginia State Corporation Commission (Tr. 116). He stated that some reports were for the parent company only, while others were consolidated reports for both the parent company and its subsidiary (RX 8).

[22]The call report contained the following attestation: "I, Dave Welch, CFO . . . of the named bank do hereby declare that the Reports of Condition and Income . . . for this report date, have been prepared in conformance with the instructions issued by the appropriate Federal regulatory authority and are true to the best of my knowledge and belief" (Tr. 69; RX 8 at 1-2).

[23] Hereinafter, all citations to this exhibit refer to its unredacted version offered into evidence at the hearing as Complainant's Exhibit 33 (the redacted version was introduced into evidence as Joint Exhibit 1).

[24] On the issue of the quality of his performance, Welch also testified that Beth Worrell had incorrectly concluded that he had made erroneous journal entries for $23,868.71 (RX 4). According to Welch, he was not at fault because he was merely following Larrowe & Co.'s instructions attached to the relevant order (Tr. 360-62).

[25]Welch testified that he intended to discuss the "journal entries [for the] sundry credits and officer expenses, the topic of insider trading, the topic of internal controls being overridden and the fact that on a number of occasions these issues had been addressed with Mr. Moore and with other officers in the company and no action had been taken to correct those issues" (Tr. 74).

[26] The outline of Welch's presentation also stated that over the past year, the CEO appeared to be interested in getting rid of Welch (and cited some examples), and that "our relationship" had been damaged beyond repair (CX 26 at 3). It also stated that, on the advice of his attorney, Welch intended to offer an option that would be "best for all parties," but which had to be "done prior to quarter's end" because "[i]f I am here when the G/L is closed for the 3rd quarter and all issues have not been addressed and fixed, I must certify that the financials are not accurate nor are they fairly presented." *Ibid.* Welch's outline reflects that the "option" included, among other, a demand for a "fair severance package" and a letter of recommendation, so that Welch would "quietly leave the bank." *Ibid.*

[27] Welch testified that this transcript from the audio tape he made at the September 20, 2002 meeting accurately represents what occurred during the meeting (Tr. 75).He denied that he willfully withheld the tape from Respondent, and testified that he was unable to provide the tape prior to his termination on October 1 because it was in the possession of his then-attorney Terry Kilgore, who was out of town (Tr. 82-83).

[28] Welch testified that in making his presentation, he relied on information concerning the Sarbanes-Oxley Act he received at a meeting of the Virginia Bankers Association for CFOs he attended on September 9 and 10, 2002 (Tr. 74, 95-96). Welch also testified that, after the conference, he corresponded via email with George P. Whitely, a Richmond attorney who made a presentation during the conference, regarding the Sarbanes-Oxley Act (Tr. 99; CX 32).

[29] Welch had never heard of this purported policy, and Cardinal never satisfied his request to produce any documentation reflecting the existence of such a policy (Tr. 72-73).

[30] Welch testified that he made a statement about three individuals being parties to fraud "after Mr. Moore had become very angry and very disruptive" (Tr. 149).

[31] Welch noted that the memorandum was delivered by Cardinal's employee who was in charge of collections from delinquent debtors (Tr. 83).

[32] Welch clarified that any references to his attorney concerning the period between September 20th and October 1 referred to Terry Kilgore, not Bruce Shine, his trial counsel. *Ibid.*

[33] This memorandum reiterated that no outside lawyers would be allowed at the meeting (JX 4).

[34] Welch testified that this request was never satisfied (Tr. 94).

[35] Welch testified that the Audit Committee and the Board of Directors normally met in the boardroom at the bank, rather than in the Profit House (Tr. 92).

[36] Hereinafter, all citations to this exhibit refer to its unredacted version offered into evidence at the hearing as Complainant's Exhibit 34 (the redacted version was introduced into evidence as Joint Exhibit 12).

[37] As noted above, on September 17, 2002, Moore met with Densmore, Larrowe, and Gardner to discuss Welch's September 13th memorandum, in which Welch related his concerns with the Forms 10-QSB for the second and third quarters of 2002 and the certifications required by the Sarbanes-Oxley Act (JX 12).

[38] Welch testified, contrary to Larrowe's representation to the committee, that he had never asked to be given authority to approve bank's contracts (Tr. 357).

[39] The record contains no other mention of this complaint allegedly made by Welch, and Complainant offered no evidence on this issue.

[40] An April 1, 2002 memorandum to Welch's personnel file, which is also part of that exhibit, notes that Welch approached Shelby Rutherford that day, was "very upset," and said he was taking a vacation day to "think things through and decide whether he would be bringing his resignation in tomorrow." (CX 31 at 1).

[41] Moore explained that after the September 11th terrorist attack, "there was a requirement by the federal government that banks be able to retrieve [information] on a short term basis" (Tr. 104). Welch

testified that the Excel spreadsheet allowed him to sort data and to retrieve it "within a matter of minutes" (Tr. 104-05). He added that the process was underway of incorporating into the worksheet the historic data that predated this novel retrieval requirement (Tr. 101).

[42] This report was copied to the Audit Committee, Moore, Vice President of Compliance Office Diane Ham, Data Processing Manager Betty Whitlock, and Welch (Tr. 101; CX 24).

[43] Welch testified that he does not know whether it would be a violation of the Act for Moore to tell him not to report his concerns to the Audit Committee or the Board (Tr. 125).

[44] More specifically, Welch listed the following reasons why this option would not be desirable for Moore: 1) the failure to comply with the Act with regard to the second quarter certification, 2) the issues surrounding the upcoming third quarter certification, 3) the evidence that would "tell a jury that [Welch] was let go because [he] stood up for what [he] believed to be right in spite of the cost of [his] job," 4) the jury being sympathetic towards him, and because 5) the Act afforded Welch whistle blower protection.

[45] This "option" also involved Moore making "no comments to anyone that might lead them to believe anything about me except that I did a good job." *Ibid.*

[46] Welch denied that he had met with Kilgore to discuss his exit strategy, but rather to address "how to approach doing a presentation to the staff of Cardinal . .

. in such a way that hopefully it wouldn't backfire on me" (Tr. 146).

[47] Welch acknowledged that on September 18th he met with his then-attorney Mr. Kilgore, who agreed that Welch was facing a choice between leaving Cardinal or "stay[ing] in there and fight[ing] the battles that I fought" (Tr. 146; JX 2 at 13).

[48] Welch testified that he wanted Newhouse to be present because he was second in command at the bank and, thus, Welch wanted him to know of the accusations made against him and hear his side of the story (Tr. 152). Welch also wanted him to serve as a witness to his conversation with Thomas (Tr. 151-52).

[49] Welch denied that a severance package was the main subject of this discussion, since neither Newhouse, nor Thomas was in a position to make this decision (Tr. 152).

[50] Bolt testified that the unredacted portions of the minutes of these two meetings accurately reflect what took place during the meetings (Tr. 169-70).

[51] This report was addressed from the Audit Committee and the Board of Directors to the Board of Directors. *Ibid.*

[52] A copy of the investigation report was part of the minutes of the October 1st Audit Committee meeting as well as the minutes of the October 1st Board Meeting (Tr. 303; JX 20, 21). Accordingly, this document appears as part of JX 20 as well as JX 21; however, the last page

of this document was mistakenly omitted from JX 20. *Id.*

[53] Bolt testified that these minutes accurately reflect what transpired during this meeting (Tr. 172).

[54] The minutes state that because of the subject matter of this meeting, "Annette Battle was excused from attendance as secretary and Moore was appointed to act in her place." *Ibid.* Accordingly, the minutes were prepared and signed by Moore and attested to by Bolt. *Ibid.*

[55] The minutes reflect that Welch was directed to stay off Cardinal's property without the prior consent of Moore, and that he later requested, and was given, permission to enter the premises for the meeting, which he eventually chose not to attend (JX 20 at 1).

[56] According to the minutes of this meeting, "[t]he Committee members were each polled and each stated that he understood and agreed with the report and its conclusions" (JX 20 at 2).

[57] The minutes also reflect that, at the conclusion of the meeting, Dr. Conduff asked Committee members if they would like to keep the "information packets" they were given during the meeting and noted that they would have to assure absolute confidentiality (JX 20 at 2). No member of the Committee chose to keep their packet and "they were turned over to the Corporate Secretary to be destroyed." *Ibid.* Bolt testified that he could not recall what these packets contained, did not know that the packets would be destroyed, and hoped that a copy of the information contained in the packets

would be preserved by Cardinal (Tr. 200-01). He further testified that Cardinal did not have a practice of turning in and destroying paperwork used by the Board and the Audit Committee to make material decisions (Tr. 202).

[58] It appears from Venson Bolt's testimony that he believed Moore showed him this document at the September 25th meeting (Tr. 182). However, the minutes of the September 25th meeting contain no attachments and make no reference to any exhibits handed out during this meeting (CX 34). By contrast, the minutes of the September 17th meeting state that "Mr. Moore read a memo dated September 13, 2002, addressed to him from Dave Welch, CFO. He also read his response to Mr. Welch's memo, also dated September 13, 2002 (See Exhibit A and B attached)" (CX 33 at 1). However, neither the redacted version of these minutes offered into evidence as JX 1, nor the un-redacted version offered into evidence as CX 33 contain these purported exhibits A and B.

[59] The minutes of the October 1st Audit Committee meeting reflect only the time when the meeting started (4:37 p.m.), but do not reflect when it ended (JX 20). However, the minutes of the meeting of the full Board of Directors show that it started on the same day at 5:59 p.m., leaving. at most. one hour and twenty two minutes for the Audit Committee meeting (JX 21 at 1). The minutes of the Board of Directors' meeting reflect that it lasted approximately thirty minutes (from 5:59 p.m. 6:29 p.m.). *Id.* at 1-2.

[60] As noted above, following the September 25th meeting, Welch was prohibited from entering

Cardinal's property without the prior consent of Moore, and was later given permission to enter the premises specifically for the purpose of meeting with Densmore and Larrowe, which he chose not to do (JX 20 at 1).

[61] She added that this requirement existed since 1996, and Cardinal's retrieval procedure was first put in place around the same time (Tr. 220).

[62] She added that when she audited Moore's personal stock transactions around the middle of 2001, she did not discuss it with Moore beforehand (Tr. 220).

[63] Gardner acknowledged that neither Middleton nor Spangler was a CPA or held a degrees in accounting from any institution of higher education, but stated that the subject of her audit "didn't have anything to do with being a CPA" (Tr. 229-30).

[64] She further testified that she discussed Welch's July 29, 2002 response to her audit report with Moore before going to the Audit Committee (Tr. 235-36; CX 24 at 1-2). Gardner stated that Moore made a handwritten notation on Welch's memorandum responding to the audit stating "Dave Your response should deal with issues in the audit and reported to Wanda She will report findings to audit comm. Thanks" (CX 24 at 5). Gardner added, however, that Moore never told her that he wanted her to be the conduit for Welch's communications with the Audit Committee (CX 24 at 5).

[65] Gardner acknowledged that Moore "wore two hats" as Chairman of the Board of Directors and as President, an employee of Cardinal (Tr. 231).

[66] She testified that Venson Bolt presided at the Audit Committee meetings, and that, although Moore was present when she reported the results of her audits, she addressed her comments to the Committee itself (Tr. 243). She also stated that sometimes the meetings continued after she left, and on some occasions Moore left the meetings prior to the conclusion of her report (Tr. 244).

[67] Gardner testified that there were eight or ten senior managers located at the main office of the Bank of Floyd (Tr. 233).

[68] Dr. Conduff, who had previously occupied this position, was not an employee of Cardinal. *Ibid.*

[69] Moore stated that he received no compensation for serving in this capacity. *Ibid.*

[70] In particular, Moore testified that, contrary to the memorandum, he did not talk with Welch on the day before it was produced, but rather earlier in the month (Tr. 262-63). He further testified that it also incorrectly stated that Moore purchased 420 shares of stock on October 1, 2001, while he actually purchased 200 shares on September 18, 2001 (Tr. 263). Finally, Moore added that when Welch informed him that a shareholder (Jenny Lane) wanted to sell her stock for $10 a share, he told Welch that that would be completely inappropriate because that price was lower than the market price. *Ibid.* Moore added that Welch could have "simply asked to see my certificate or see my information I'd been happy to provide them for him" (Tr. 264).

[71] However, Moore later stated that he first talked to his broker "as early as late February or early March" (Tr. 250, 253)

[72] Moore defined a "trade date" as the "actual date that the investment company executed that order for purchase of stock" (Tr. 249).

[73] The full list of state bank examiners who examined Cardinal's operations in the summer of 2002 is found in CX 14 at 1 (Tr. 274). According to Moore, the state examination continued approximately through August 15, 2002 (Tr. 279).

[74] Moore added that as a witness in this case, he was not testifying on behalf of the Board of Cardinal as to why Mr. Welch was terminated (Tr. 280).

[75] Cardinal had made an investment in Virginia Bankers Insurance and was considering forming an insurance company (Tr. 259).

[76] Moore added that "all of them are listed in the telephone directory . . . [and] on our report that we do after the annual meeting." *Ibid.*

[77] The Liability Committee also included Fred Newhouse and Moore. *Ibid.*

[78] "Just before lunch, just after lunch and then at 3:00 o'clock in the afternoon" (Tr. 290).

[79] This name is misspelled in the record as "Jeff Endorf." *Ibid.*

[80] Larrowe explained that this provision represented the management's best estimate of the reserve necessary to account for the losses in the portfolio (Tr. 313).

[81] He added, however, that "audit contracts" language would be "nonsensical to me because the only person that would approve an audit contract would be the audit committee itself" (Tr. 317).

[82] Larrowe clarified that there is a difference between the disclosure controls relating to Sarbanes-Oxley and internal controls in that the former are essentially a sub-set of the latter. He further clarified that

Internal controls, by and large, are those controls that are there . . . to ensure the accuracy of the financial statements and the safety and soundness of the assets under control of the institution. The disclosure controls, on the other hand, are essentially tools that are in place to assure that whoever the preparer of the financial statements and related disclosures happens to be, that that individual has all of the relevant information available to them.

(Tr. 351).

[83] According to Larrowe, "on at least September 25th," the Audit Committee affirmed that Welch had this responsibility (Tr. 327).

[84] He acknowledged that Worrell was a CPA and a managing partner on Cardinal's account (Tr. 298).

[85] He added that because in 2001 he "wasnot the partner in charge on the engagement so I normally would not talk with either" (Tr. 338).

[86] Later, however, Larrowe provided conflicting testimony when he stated that

[87] As noted above, in this copy of the representation letter Welch had incorporated references to his August 2, 2002 letter to Worrell under three specific representations (CX 17).

[88] He added that he is certain that Worrell did not receive these attachments either because she would have showed them to him (Tr. 334).

[89] Larrowe acknowledged that he knew about the existence of the Financial Accounting Statement Standard No. 140, but did not know what it states regarding the entry of sundry accounts (Tr. 335).

[90] He noted that this certification: "says, initially, that management is responsible for the fair presentation of the financial statements, results of operations and cash flows. It further indicates that all financial records and related data have been made available, all minutes have been made available . . . . It says . . . there have been no irregularities involving other employees that could have a material effect on the financial statements" (Tr. 352).

[91] *See, e.g.*, Energy Reorganization Act, 42 U.S.C. § 5851 (protecting, *inter alia*, employees from retaliation by licensees of nuclear power facilities from discharge or other discrimination because of reporting suspected

safety violations); Clean Air Act, 42 U.S.C. § 7622 (protecting, *inter alia*, employees from retaliation by employers for participating or assisting in the administration, implementation, or enforcement of the Clean Air Act); Wendell H. Ford Aviation Investment and Reform Act for the 21st Century (AIR21), 49 U.S.C. § 42121 (protecting, *inter alia*, employees of air carriers from discharge or other discrimination from reporting safety violations). Indeed, the Act expressly provides that proceedings under Sarbanes-Oxley are to be governed by the rules and procedures, as well as burdens of proof, of AIR21, 49 U.S.C. § 42121(b). 18 U.S.C. § 1541A(b)(2)(A),(C). Similarly, DOL's Interim final rule governing the employee protection provisions of Sarbanes-Oxley notes that the role federal agencies are to play in cases brought under the Act is the same as their role set forth in the AIR21 and ERA regulations. Fed. Reg., Vol. 68, 31860, 31861 (May 28, 2003).

[22] Welch testified that, in June, 2001 (second quarter), residual payments on lease assignments in the amount of $45,000 were recorded as other income' and in July, 2001 (third quarter), a $150,000 settlement received from a "Sully Tech" judgment on a charged off loan was improperly recorded as "Income From Other Real Estate" (Tr. 55, 315-16; JX 1, 12).

[23] Welch noted that "some people would argue that if a recovery like this had been taken to the . . . balance sheet account, then the expense account could have been reduced accordingly . . . . In other words, at September 30th we could have reduced the expense put into that account through October, November, December, but the federal call reports prohibit you

[from] going back and [reducing the expenses to offset a recovery that was put in the allowance account]. Once those entries are made July, August and September you can't just reverse those, you have to reduce future expenses to offset that. So, at this point in time the financials were inaccurate" (Tr. 52-53).

[24] Welch's expert, Wynne E. Baker, also agreed that the bank's recording of the $195,000 was improper. He wrote:

It is a long standing bank industry practice that if a loan is charged off the bank books, the recovery of that charge off should be recorded as an increase to the allowance for loan and lease losses. After the entry is made to the allowance for loans and lease losses, and before a quarterly reporting period, the Board of Directors is to determine if the allowance for loan and lease losses is adequate to meet the possible risks in the portfolio of loans.

(CX 30 at 2). Baker is a CPA and the member in charge of KraftCPAs financial institution industry group. *Id.* at 4. His resume notes that he earned the chartered bank auditor certificate awarded by the Bank Administration Institute, is a preferred examiner under the American Bankers Association Preferred Audit Program, and is a certified financial services auditor awarded by NAFSA. *Ibid.*

[25] Welch insisted that these figures had to be restated in the income statement, balance sheet, and cash flow statement for the third quarter of 2001, since all these documents would be included in the Form QSB filed with the SEC (CX 23; Tr. 42).

[26] The report stated:

Again, if Mr. Welch legitimately believes his access to Larrowe & Company has been restricted, he should have informed the Committee of this in a timely fashion. He has made no effort to do so. Nonetheless, the Committee has reaffirmed to Larrowe & Company that the Company's chief financial officer is to have unrestricted contract with them.

(CX 21 at 6).

[27] Welch made this allegation in his August 2, 2002 letter to Beth Worrell (CX 17) and during the September 20th meeting (JX 2 at 7-8). He also reiterated it in his August 14th and September 13th memoranda to Moore as grounds for his refusal to sign Cardinal's third quarter certification (CX 20; CX 23 at 2-7; Tr. 49).

[28] In his August 14th memorandum to Moore, Welch wrote: "as I have stated to you on numerous occasions in the past, when there are so many people making journal entries without my knowledge or approval, I cannot give any assurances that our financials are fairly presented" (CX 20).

[29] Financial Accounting Statement Standard No. 140 (Tr. 335).

[100] Welch helped develop a job description for the CFO position about a year after he started working at Cardinal (Tr. 28). Excerpts from the job description are included in Welch's September 13, 2002 memorandum to Leon Moore. They include:

"Compiles and analyzes financial information to prepare entries to accounts, such as general ledger accounts, documenting business transactions." "Determines proper handling of financial transactions and approves transactions within designated limits." "Monitors compliance with generally accepted accounting principles and company procedures." "Audits contracts, orders, and vouchers, and prepares reports to substantiate individual transactions prior to settlement", and "Reviews, investigates, and corrects errors and inconsistencies in financial entries, documents, and reports."

(CX 23 at 4).

[101] Baker, as noted above, is a CPA and the member in charge of KraftCPAs financial institution industry group (CX 30 at 4).

[102] Thus, there is no need to decide the contested issue of whether or not Respondent was aware of Welch's e-mail to Fred Doyle, a state bank examiner.

[103] William Gardner is unrelated to Wanda Gardner, the bank's internal auditor (Tr. 21).

[104] Howard Conduff, William Gardner, C.W. Harman, Kevin Mitchell, and Dorsey Thompson.

[105] Notably, this discussion is not recorded in the minutes (CX 33).

[106] He recalled, however, that Moore showed him his response to Welch's September 13th memorandum. *Ibid.*

[107] Although the minutes of the September 17th meeting reference "Exhibit A and B attached" (CX 33 at 1), Respondent never submitted any such exhibits into evidence and the minutes state only that Moore read Welch's September 13th memorandum and his response to that memorandum during this meeting (CX 33 at 1).

[108] Some of the Board members also appear to lack any substantial education or experience with respect to the financial affairs of banks. For example, Doctor Conduff is a dentist, Mr. Miller is a dairy farmer, and Mr. Thompson is a farmer (Tr. 173).

[109] Densmore's and Larrowe's repeated claim that Welch failed to report his concerns sooner and that he should have reported them directly to the Audit Committee. was unwarranted. Larrowe acknowledged that Welch wrote a letter to Larrowe & Co. expressing his concerns three days after Sarbanes-Oxley was enacted (Tr. (Tr. 331-32). During the months of August and September, Welch repeatedly reported his concerns to Moore (CX 20, 23). He explained that he reported his concerns to Moore because Moore "had the responsibility to report to the Board of Directors or the Audit Committee" (Tr. 139) and because he feared termination and losing his career in banking (Tr. 125). Venson Bolt confirmed that, as the President and Chairman of the Board, Moore was expected to report any significant developments to the Committee, but he never reported Welch's complaints against him until September, 2002 (Tr. 194-95). Moore acknowledged that

he did not show Welch's August 14th memorandum to the Board of Directors for approximately thirty days after he had received it (Tr. 267; CX 20).

[110] Those same minutes reflect that Van Doren, an attorney with Densmore's firm, stated "Mr. Welch has no right to have a third party attorney present for a discussion of internal bank matters, particularly since they are sensitive and confidential and relate to publicly traded securities." CX 12 at 7. None of the Committee members expressed any similar misgivings about Welch attending such a meeting with his personal attorney.

[111] Respondent's suggestion that Complainant's activities were in furtherance of a desire to force Cardinal to "buy his silence with a fair' severance package . . . ." is not credible. Resp. Br. At 25. Complainant testified, and the record adequately demonstrates, that he had legitimate concerns regarding the accuracy and adequacy of Cardinal's disclosures of various financial information. The record further establishes that he reported his concerns to Cardinal's management and others, not so he could extort from Cardinal a favorable severance package, but out of a genuine desire to force Cardinal's compliance with the new and more stringent reporting requirements of Sarbanes-Oxley. Furthermore, as explained above, Complainant credibly explained why, prior to Sarbanes-Oxley, he was willing to sign financial statements which may not have been completely accurate but, in light of the significant penalties imposed by the Act, he could not do so thereafter. While Complainant's concerns with respect to his continued employment at Cardinal were genuine, and,

under the circumstances presented here, understandable, I find those concerns were not the motivating factor behind the complaints he raised regarding Cardinal's financial information.

[112] *See* September 20, 2002 memorandum from Moore to Welch stating "You are directed to meet with the Company's legal counsel . . . and will be asked to present all information *you have* relating to your allegations of fraudulent conduct by Company officers or employees or any other serious matters you think need to be addressed." (JX 3) (emphasis added).

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No. 07-1684
UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

DAVID E. WELCH, CPA,
Petitioner,

SECURITIES AND EXCHANGE COMMISSION,
Amicus Curiae.

v.

ELAINE L. CHAO, SECRETARY OF LABOR,
UNITED STATES DEPARTMENT OF LABOR,
Respondent,

CARDINAL BANKSHARES CORPORATION,
Intervenor-Respondent.

GOVERNMENT ACCOUNTABILITY PROJECT;
NATIONAL WHISTLEBLOWER CENTER;
TAXPAYERS AGAINST FRAUD,
Amici Supporting Petitioner,

AMERICAN ASSOCIATION OF BANK
DIRECTORS; VIRGINIA ASSOCIATION OF
COMMUNITY BANKS; VIRGINIA BANKERS
ASSOCIATION,
Amici Supporting Respondent,

ORDER

The Court denies the petition for rehearing and rehearing en banc. No poll was requested on the

petition for rehearing en banc.

Entered at the direction of the panel: Judge Motz, Senior Judge Hamilton and Senior Judge Hilton.

23

No. 08-836

FILED

MAR 9 - 2009

OFFICE OF THE CLERK
SUPREME COURT, U.S.

In The Supreme Court of the United States

DAVID E. WELCH,

Petitioner,

v.

ELAINE L. CHAO, SECRETARY OF LABOR, UNITED STATES DEPARTMENT OF LABOR, AND CARDINAL BANKSHARES CORPORATION,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF IN OPPOSITION

Betty Southard Murphy
Counsel of Record
Marc A. Antonetti
BAKER & HOSTETLER, LLP
1050 Connecticut Ave., NW
Suite 1100
Washington, DC 20036
(202) 861-1500

Joseph M. Rainsbury
LECLAIRRYAN
1800 Wachovia Tower
Drawer 1200
Roanoke, Virginia 24006
(540) 510-3055

Douglas W. Densmore
GENTRY, LOCKE, RAKES & MOORE, LLP
10 Franklin Road, SE
Post Office Box 40013
Roanoke, Virginia 24022
(540) 983-9399

Counsel for Respondents

LANTAGNE LEGAL PRINTING
801 East Main Street Suite 100 Richmond, Virginia 23219 (800) 847-0477

QUESTION PRESENTED

Is a federal court reviewing an administrative agency's decision required to consider new legal arguments and authorities that the claimant never presented to the agency?

CORPORATE DISCLOSURE STATEMENT

Respondent Cardinal Bankshares Corporation is a publicly held corporation. It has no parent corporation and no public corporation owns more than 10% of its stock.

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REASONS FOR DENYING THE WRIT 13

I. The Court of Appeals correctly held that Welch waived his protected-activity arguments by not first presenting them to the Department of Labor. 15

II. There is no conflict in the circuits on the proper standard for evaluating protected activity in whistleblower cases brought under 18 U.S.C. § 1514A. 20

A. The three courts of appeals that have addressed the issue apply a uniform standard for protected activity 20

B. Welch's statistical arguments are both inappropriate and unsound. 22

III. Welch's belated arguments to this Court and to the Court of Appeals also fail on the merits. 23

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PRELIMINARY STATEMENT

This Court should deny certiorari since the Court of Appeals' decision correctly applied the principle that a party challenging an agency's action may not raise arguments that were never presented to the agency. In his Petition, Welch does not even mention, let alone challenge, the Court of Appeals' dispositive ruling on the waiver issue. Instead, he attempts to raise arguments about the substantive elements of Sarbanes-Oxley whistleblower claims. Because of its waiver holding, however, the Court of Appeals never even *reached* those issues. That forecloses their consideration here. But even assuming the Court of Appeals had reached those issues, the Petition still should be denied because (1) it does not raise legal questions on which there is a conflict among the courts of appeals, and (2) Welch's claim that the generally accepted accounting principles allegedly in dispute in this case can be the basis for a Sarbanes-Oxley whistleblower complaint lacks any support in the record and in the law. As this case was completely, and correctly, decided on waiver grounds, it does not present any issue worthy of certiorari.

STATEMENT OF THE CASE

Factual Background

Because the Petition contains a number of material inaccuracies and omissions, Respondent presents the following restated summary of facts.

Respondent Cardinal Bankshares Corporation[1] is a bank holding company whose sole asset is the Bank of Floyd, a small community bank in rural southwest Virginia.[2] The Bank hired Petitioner David Welch, a certified public accountant, in February 1999. Welch started as a part-time accounting officer. A year later, however, Welch requested full-time employment and the title of Chief Financial Officer. The Bank's President and Chief Executive Officer, Leon Moore, agreed. (JA 139-40, 303-05).[3]

Welch's own notes show that as early as 2001 he understood that his job was in jeopardy because of performance issues and a perceived lack of trust in him. (JA 204). In addition, Welch believed that a proposed merger put his position at risk, writing that "(w)ith a merger, elimination of positions are [sic] likely." (JA 141, 306, 315).

Welch's worries over his position were compounded in August 2002, when the Bank received an unfavorable examination by state banking regulators—largely as a result of recurring errors in the "call reports" that Welch prepared. (JA 147-50). Although Welch certified those reports when they were submitted, he gave shifting accounts of his role in their preparation. The senior examiner stated

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[1] Cardinal Bankshares Corporation is not affiliated with "Cardinal Bank," the much larger DC-area bank.

[2] Unless the context requires otherwise, Respondent will refer to the Cardinal Bankshares Corporation and the Bank of Floyd as "the Bank."

[3] "JA" references are to the Joint Appendix filed with the Court of Appeals.

that Welch had blamed many of the errors on the Bank's outside auditors who, the examiners stated, Welch said prepared one of the most problematic reports (the March 2002 report) while he was on sick leave. (JA 147). At trial, Welch acknowledged that he had prepared the erroneous March 2002 report before going on sick leave. He denied, however, that he had blamed the deficiencies in that report on others. (JA 88).

In early September 2002, a month after Congress enacted Sarbanes-Oxley, Welch attended a seminar on the statute. (JA 75-76). Afterwards—and with the Bank's merger looming—Welch accused various Bank employees, including CEO Leon Moore, of accounting improprieties. These accusations mostly concerned transactions that had occurred a year earlier, in the second and third quarters of 2001. (JA 193, JA 276).

Welch's primary complaint was an alleged accounting misclassification of $195,000. (JA 62). The $195,000 represented recoveries on a previously written-off loan and a residual payment on a lease. These recoveries had been credited directly to income. Welch, however, claimed that banking regulations required the Bank first to credit the recoveries to the reserve account for loan losses; the recoveries would flow to income only indirectly, through an offsetting reduction in provision expense.[4] (JA 63-64, JA 178).

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[4] Banks must allocate funds to keep their reserve accounts at adequate levels. This is reflected in the "provision" expense item in income statements.

Although Welch and the Bank disagreed whether accounting principles required the recoveries to be treated as Welch alleged, there is no dispute that—however characterized—the Bank had in fact recovered *$195,000 of additional money that it previously* did not have, the receipt of which increased the Bank's net income by $195,000. (JA 63-64, JA 178). Moreover, even though Welch disagreed with the Bank's accounting treatment of the $195,000, he certified the second and third quarter 2001 financial statements as accurate. (JA 104).

In September 2002, however, Welch stated that he would not certify the Bank's third-quarter *2002* financial reports because they included, for comparison purposes, the third-quarter *2001* figures. (JA 64). Welch's only evidence of the materiality of this alleged misclassification was his observation that the Bank's stock price increased between September and October 2001. He claimed that stockholders were enticed to purchase the Bank's shares during this period because of the Bank's treatment of the $195,000 recoveries. (JA 62). But even though the third quarter ended on September 30, 2001, the third quarter *report* that included the $195,000 was not released until November 14, 2001. (Pet. App. 45a n.16). Thus, the allegedly misleading report had not even been published at the time Welch claimed the public had been misled by it.

Welch also claimed—again, with no evidentiary support—that his access to the Bank's external auditing firm had been restricted. Even though Welch had previously worked at the same auditing firm, he complained that the firm regularly communicated with the Bank's CEO and not with him. There are multiple pieces of correspondence between Welch and

the auditing firm that disproved this claim. (JA 164).

Finally, Welch complained about internal procedures at the bank. At the Bank of Floyd, like most small community banks, employees without specific journal accounting training make entries in the general ledger. (JA 165). Welch alleged, however, that this meant the Bank had "inadequate internal controls." (JA 69, JA 277). But even though Welch was responsible for the Bank's financial accounting, was responsible for reviewing the entries, and claimed to have concerns about them, he never reviewed the entries. (JA 25, 68). And he never claimed that anyone at the Bank prevented him from doing so, either.[5]

Instead of communicating his concerns to the Bank's Audit Committee, Welch threatened Bank employees with a Sarbanes-Oxley charge unless he received a buyout. On September 20, 2002, Welch convened a meeting of Bank employees on the pretence of giving them a presentation on Sarbanes-Oxley. (JA 110). Instead, Welch accused several of his co-workers of fraud. Welch tape-recorded that portion of the meeting. (JA 193). He did *not* record the second half of the meeting, which involved his attempt to negotiate a severance package with Marie Thomas, the Bank's Humans Resources Director, and

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[5] Welch also accused CEO Leon Moore of insider trading—allegations that the ALJ failed to find had any factual basis. Welch never appealed the ALJ's failure to find protected activity for these false accusations and does not now claim that these allegations of insider trading constituted protected activity. Nevertheless, Welch repeats the insider-trading claims in his Petition.

Fred Newhouse, the bank's Executive Vice President. (JA 113, JA 116). But as the notes that Welch prepared for the meeting reveal, he wanted the Bank to vest his retirement benefits, pay him a bonus, pay him a severance package, and provide a good reference. Welch said that if the Bank did this he would, in his own words:

> "Just quietly leave the bank." (JA 204)
>
> "[W]ith reasonable severance package—6:00—gone." (JA 307)
>
> He would "just ride off into the sunset." (JA 116).

Welch warned that discharging him "might not be the wisest choice" because he could bring a "whistleblower protection" suit under Sarbanes-Oxley. (JA 306-07).

Rather than pay Welch to "quietly leave the bank," CEO Leon Moore—one of the persons Welch had accused of wrongdoing—informed the Audit Committee of Welch's complaints. (JA 292-93). The Audit Committee retained outside counsel and an outside accountant to investigate Welch's accusations.[6] The investigators sought to meet with Welch and assured him that he was not a target of the investigation. (JA 205, JA 221, JA 223). Instead of explaining his concerns to the Audit Committee investigators, however, Welch refused to meet with them unless his personal lawyer was present. (JA 225).

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[6] CEO Moore recused himself and took no part in the investigation (JA 191) or in the subsequent Audit Committee's deliberations. (JA 231-32).

Because the investigation concerned internal, confidential, and sensitive matters involving the Bank (a public company), the Audit Committee rejected Welch's demand to have his lawyer present during the internal investigation of Welch's own allegations.[7] (JA 223). The Audit Committee chairman assured Welch that the subject of the meeting did not involve Welch's own employment issues; rather, it concerned the accusations that Welch had leveled at other employees. (JA 221). Nevertheless, the Audit Committee stated that Welch's cooperation with the investigation *was* a condition to his continuing employment. (JA 221, JA 223).

Although he was given multiple opportunities to meet with the Audit Committee investigators, Welch repeatedly refused to do so without having his lawyer present. Welch's lawyer confirmed this refusal in a letter to the Bank, stating that Welch would not attend a meeting with the investigators without his personal attorney present. (JA 225, 228). The Bank refused to yield to these demands.

Meanwhile, the representatives hired by the Audit Committee to review Welch's allegations of wrongdoing continued their investigation—albeit without Welch's assistance. They found no evidence of wrongdoing by other Bank employees. Relying on the investigators' report, the Audit Committee concluded that Welch's complaints were either unfounded, immaterial, or both. (JA 233-37).

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[7] In addition to the other reasons, it would have been inappropriate to have Welch's outside lawyer present because of the pending merger and other confidential items which might arise.

Because Welch—the Bank's CFO—had disobeyed the Audit Committee's instructions to cooperate in its investigation of Welch's own accusations, the Audit Committee recommended to the Board of Directors that Welch be discharged for insubordination. (JA 232). The Board accepted this recommendation and discharged Welch. (JA 238-39).[8]

The OSHA investigation and the decision of the Administrative Law Judge

Shortly thereafter, Welch commenced a whistleblower action under 18 U.S.C. § 1514A. This section gives whistleblower protection to employees who "provide information . . . regarding any conduct which the employee reasonably believes constitutes a violation of section 1341 [mail fraud], 1343 [wire fraud], 1344 [bank fraud], or 1348 [securities fraud], any rule or regulation of the [SEC], or any provision of Federal law relating to fraud against shareholders . . . ." 18 U.S.C. § 1514A(a)(1). Such complaints must be brought initially in the Department of Labor. 18 U.S.C. § 1514A(b)(1)(A).

The implementing regulations require a complainant to show (1) he engaged in protected activity; (2) his employer knew, actually or constructively, of the protected activity; (3) he suffered an unfavorable personnel action; and (4) the circumstances raise an inference that the protected activity was a contributing factor in the personnel action. 29 C.F.R. § 1980.104(b). To establish "protected activity," the employee must show that he had "both 'a subjective belief and an objectively reasonable belief that the

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[8] CEO Moore took no part in the decision to terminate Welch. (JA 140; JA 280).

conduct he complained of constituted a violation of relevant law.'" (Pet. App. 11a) (quoting *Livingston v. Wyeth*, 520 F.3d 344, 352 (4th Cir. 2008)). The regulations give OSHA the initial responsibility to investigate claims. *See* 29 C.F.R. 1980.104 (requiring the Assistant Secretary to conduct an investigation); 29 C.F.R. § 1980.101 (defining "Assistant Secretary" as "the Assistant Secretary of Labor for Occupational Safety and Health").

The OSHA investigator in this case dismissed Welch's complaint, finding that the Bank had a legitimate reason for discharging Welch—namely, Welch's refusal to discuss his allegations of fraud without having his personal lawyer present. (JA 48).

Welch requested an evidentiary hearing before an Administrative Law Judge. The ALJ conducted a hearing and ruled in Welch's favor. Relevant here, the recommended decision and order identified three "violations" that the ALJ claimed were sufficient to constitute protected activity under SOX:

(1) The Bank erroneously classified a $195,000 recovery as income rather than as a credit to loan-loss provision;

(2) The Bank had allowed certain persons without accounting experience to make entries in its ledger; and

(3) The Bank had restricted Welch's access to outside auditors.

(Pet. App. at 143a-156a). The ALJ, however, never identified any law that these items implicated. He never linked the "violations" to any of the statutes enumerated in Section 1514A.

The decision of the Administrative Review Board

The Bank appealed the ALJ's ruling to the Department of Labor's Administrative Review Board ("ARB"). 29 C.F.R. § 1980.110. In its briefs to the ARB, the Bank pointed out that neither the ALJ nor Welch had ever explained how any of the so-called "violations" related to any of the laws enumerated in Section 1514A. (Pet. App. at 16a-17a).[9]

Welch—who was represented by experienced counsel at all stages of this case—failed to cite any relevant statute or regulation that he believed was violated. Instead, he offered broad generalizations about the purposes of securities laws and Sarbanes-Oxley. He claimed that the Bank's conduct violated the broad "purposes" of securities laws, as stated on the SEC's website. And he quoted accounting treatises rather than the statutes and regulations enumerated in Section 1514A. Welch never "tied" the specific "violations" to any specific law.

The ARB found that Welch's arguments were wholly inadequate to establish that he had engaged in protected activity under Section 1514A. With respect to the $195,000 recovery, the ARB made two alternate findings. It first noted that the Bank had actually received the $195,000. At worst, the error was one of misclassification. The ARB found that it was not misleading for the Bank to report the recovery as income since it was, in fact, new money received.

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[9] Cardinal asserted other grounds for reversing the ALJ opinion, but the ARB did not need to reach those arguments.

In its second holding—the one the Court of Appeals ultimately affirmed—the ARB noted that Welch failed to present any legal authority to support his claim of protected activity. It observed that Welch appeared to be arguing that any violation of the standards imposed by GAAP, GAAS, or FFIEC were ipso facto violations of federal securities law because those standards have the same investor-protection purposes as the securities laws. (Pet. App. 38a). The ARB correctly noted, however, that neither the text of Section 1514A nor the rules promulgated thereunder substantiated Welch's argument. Thus, the ARB observed that *"Welch has not supported this argument with any authority."* (*Id.*) (emphasis added).

The ARB made similar rulings on the remaining two items identified by the ALJ, stating that neither Welch nor the ALJ had explained how those "violations" implicated the federal securities laws—an essential condition if such complaints were to constitute protected activity. (Pet. App. 40a, 42a). Because Welch failed to support his argument with any relevant authority, the ARB found that he had failed to establish protected activity and, thus, it denied his complaint. (Pet. App. 42a).

The decision of the Court of Appeals

Welch appealed the matter to the Court of Appeals, which affirmed the ARB. In an unanimous panel opinion authored by Judge Motz, the Court of Appeals agreed with the ARB's "second rationale for its dismissal of Welch's complaint," namely that "Welch . . . failed to explain to the ARB how he could have had an objectively reasonable belief that these actions violated any of the laws listed in § 1514A." (Pet. App. at 15a-16a).

In analyzing this issue, the Court of Appeals reviewed the materials that had been submitted to the ARB. Indeed, after oral argument it obtained the full 11-volume administrative record.[10] The court's opinion reflects a review of the full record. For example, even though the parties had not included their ARB briefs in the Joint Appendix, Judge Motz quoted extensively from those briefs in her analysis of the ARB's decision. (Pet. App. 16a-17a).

After its review of the administrative record, the Court of Appeals reached the same conclusion as the ARB: Welch "utterly failed" to present the ARB with any relevant legal argument to support his position that the three "violations" identified by the ALJ related to any violation of the statutes or regulations enumerated in Section 1514A. (Pet. App. at 17a). The court observed, for example, that Welch's arguments to the ARB about the $195,000 in the third-quarter 10-QSB report relied, in part, on "regulations passed years *after* the filing of that report." (Pet. App. 20a n.5). It pointed out that Welch cited "regulations which clearly do not fall within the purview of § 1514A." (*Id.*). And it noted that Welch cited "general accounting standards and the general purpose of the securities laws" but failed before the ARB to "explain—as he attempts to on appeal—how a person could reasonably believe that the failure to correct the 10-QSB report might violate any relevant federal law or applicable SEC regulation." (*Id.*). For the

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[10] *See* Case No., 07-1684, Docket Entry #109, dated June 16, 2008 (reflecting receipt of 11-volume record). The Department of Labor previously had submitted a certified list in lieu of the complete administrative record. *See* Docket Entry #38, dated October 5, 2007.

other alleged instances of protected activity, too, the Court found that no apposite legal argument had been presented to the ARB. (*Id.*).

Because Welch had "completely failed to raise any relevant arguments before the ARB," the Court of Appeals upheld the ARB's ruling that Welch had not engaged in protected activity. (Pet. App. 17a-18a) (*citing Hall v. U.S. Dep't of Labor, Admin. Rev. Bd.*, 476 F.3d 847, 861 n.8 (10th Cir. 2007), *cert. denied* 128 S. Ct. 489 (explaining that the ARB is not required to "*sua sponte* raise legal theories referenced only obliquely by a party but not clearly articulated in its briefs") and *Taylor v. U.S. Dept. of Labor*, 440 F.3d 1, 8-9 (1st Cir. 2005) (stating that "appellants have forfeited the argument by failing to raise it during the administrative proceedings")).

This appeal followed.

REASONS FOR DENYING THE WRIT.

This Court should deny certiorari for three independently sufficient reasons.

First, Welch's "Questions Presented" fail to address the actual basis for the Court of Appeals' decision. The Court of Appeals affirmed the ARB's decision because Welch had "utterly failed" to present the ARB with any legal authority to support his protected-activity argument. (Pet. App. 17a). The court refused to entertain any of Welch's new arguments, observing that Welch had waived those points by not raising them in his arguments to the ARB. In his Petition, however, Welch completely ignores this dispositive basis for the Court of Appeals' decision. His "Questions Presented" instead raise issues relating to the substantive requirements for protected activity under Section 1514A. But the Court of Ap-

peals never even *reached* those questions, deciding the case entirely—and appropriately—on waiver grounds. Because the questions that Welch asks this Court to address are not properly presented in this appeal, the Court should deny certiorari.

Second, even if the Court of Appeals had reached the merits of the protected-activity issue, there is no conflict among the circuits that would warrant certiori. To date, only three circuits—the First Circuit, the Fourth Circuit and the Fifth Circuit—have addressed the requirements for protected activity in Sarbanes-Oxley whistleblower cases. All three circuits have analyzed the issue identically, adopting an objective-reasonableness standard. Accordingly, there is no inter-circuit conflict that this Court needs to resolve.

Third, Welch's protected-activity argument fails even on its own terms. Welch argues that GAAP violations are violations of Sarbanes-Oxley and, thus, complaints about perceived GAAP violations can be the basis for Sarbanes-Oxley whistleblower claims. Yet Welch fails to support this argument with any legal authority that establishes that GAAP violations are per se violations of Sarbanes-Oxley. Moreover, there is no basis in the record for his claim that the alleged misclassification of the $195,000 was a GAAP violation. So even if the merits of his protected-activity arguments were reviewable in this appeal—and they are *not*, because the Court of Appeals decided the case on waiver grounds—his arguments still fails as a matter of law.

For all these reasons, amplified below, this Court should deny certiorari.

I. THE COURT OF APPEALS CORRECTLY HELD THAT WELCH WAIVED HIS PROTECTED-ACTIVITY ARGUMENTS BY NOT FIRST PRESENTING THEM TO THE DEPARTMENT OF LABOR.

Welch's "Questions Presented" are noteworthy for what they do not include. They do *not* encompass the issues that actually led the Court of Appeals to affirm the ARB's decision. The legal basis for the Court of Appeals' decision—stated clearly in Section IV.B of its opinion and reproduced on pages 15a-18a of the Petitioner's Appendix—was that Welch failed to present any relevant legal argument to the ARB showing how the matters about which he complained implicated the laws encompassed by Sarbanes-Oxley's whistleblower provision. The Court of Appeals properly refused to entertain legal arguments that had not first been presented to the ARB: "We . . . hold that Welch completely failed to raise any relevant arguments before the ARB and may not now raise new arguments before this court." (Pet. App. at 18a).

Welch does not challenge this waiver holding in his Petition. He does not, for example, claim that the Court of Appeals erred in holding that a federal court may not consider arguments that were not first raised in the agency under review. Nor does Welch identify any error in applying that rule to the history of this case. Thus, Welch's appeal does not challenge the legal basis for the Court of Appeals' decision.

Welch likely has ignored the Court of Appeals' waiver analysis because the legal principles underlying it are settled and raise no novel issues meriting this Court's review. Under the doctrine of "issue exhaustion," a reviewing court may not reverse an agency adjudication on grounds that were not first

presented to the agency itself. *Sims v. Apfel*, 530 U.S 103, 108 (2000); *Hormel v. Helvering*, 312 U.S. 552, 556 (1941); *United States v. L.A. Tucker Truck Lines, Inc.*, 344 U.S. 33, 36 (1952). This requirement is particularly stringent in cases involving *adversarial* agency proceedings: "Where the parties are expected to develop the issues in an adversarial administrative proceeding, it seems to us that the rationale for requiring issue exhaustion is at its greatest." *Id.* at 110 (citing, *inter alia*, *Hormel*, 312 U.S. at 556, and *L.A. Tucker Truck Lines, Inc.*, 344 U.S. at 36).

Sound policy considerations underlie the issue-exhaustion doctrine. Respect for the administrative process is foremost:

> The responsibility of applying the statutory provisions to the facts of the particular case was given in the first instance to the Commission. A reviewing court usurps the agency's function when it sets aside the administrative determination upon a ground not theretofore presented and deprives the Commission of an opportunity to consider the matter, make its ruling, and state the reasons for its action.

Unemployment Compensation Commission of Alaska v. Aragon, 329 U.S. 143, 155 (1946). But concern for orderly procedure and fairness to the other participants in the process also factor into the equation: "Simple fairness to those who are engaged in the tasks of administration, and to litigants, requires as a general rule that courts should not topple over administrative decisions unless the administrative body not only has erred but has erred against objec-

tion made at the appropriate time . . . ." *L.A. Tucker Truck Lines, Inc.*, 344 U.S. at 37.

In the present case, the Court of Appeals properly refused to entertain legal arguments that Welch had not raised before the ARB. As noted above, the Court of Appeals—having the complete administrative record before it—searched for any relevant legal argument that linked the alleged GAAP, GAAS, and FFIEC "violations" to the actual statutes and regulations encompassed by Section 1514A. Like the ARB's own review of Welch's arguments, however, the Court of Appeals found nothing.

Welch's arguments to the ARB contained only broad generalizations about the purposes of the securities laws, quotations from accounting treatises, and irrelevant or inapplicable laws and regulations. Absent from his argument was any attempt to connect, in a concrete way, the specific matters he complained about with any law covered by Sarbanes-Oxley's whistleblower provision. As the Court of Appeals found, "[Welch] never explained how a person could have an objectively reasonable belief that this conduct violated any of the laws listed in § 1514A." (Pet. App. at 21a, n.5).

Although the waiver issue was decisive for the Court of Appeals, Welch fails to address it in his Petition. He does not, for example, identify where—in his argument before the ARB—he cited any authority showing that the "violations" identified by the ALJ actually related to the securities laws encompassed by Section 1514A. Nor does Welch explain which of his current legal arguments he actually

presented to the ARB.[11] Instead, Welch ignores the waiver issue altogether and argues the merits of the protected-activity question as if the waiver problem did not even exist.

The waiver problem *does* exist, and it is fatal to Welch's Petition for two reasons. First, it limits the questions properly reviewable on appeal. Because the Court of Appeals decided the appeal on the threshold procedural ground that Welch failed to present his arguments to the ARB, it did *not* reach—nor was it required to reach—the merits of Welch's protected-activity arguments. It simply held that, whatever the merits of Welch's newly asserted legal arguments, the court could not address them because Welch had not first presented them to the ARB. Because the Court of Appeals decided the matter on waiver grounds, the case was not (and is not) a proper vehicle to address the substantive issues relating to Sarbanes-Oxley whistleblower claims that Welch attempts to raise in his Questions Presented.

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[11] The only reference to the waiver issue appears on page 17 of his Petition, which states "Petitioner made this precise argument before both the court of appeals and the ARB." He is referring to his argument that violations of GAAP are ipso facto violations the securities laws—including Sarbanes-Oxley—and thus can serve as the predicate for protected activity under § 1514A. But as the ARB pointed out in its opinion, Welch never cited any relevant law to support this bare argument. (Pet. App. at 38a). The Court of Appeals, too, remarked on the absence of any relevant authority to support this argument. (Pet. App. at 17a, 20a-21a n.5). In his Petition, Welch fails to identify what laws he cited to the ARB to support his argument that complaints about perceived violations of GAAP or GAAS standards amount to complaints about violations of the federal securities laws referenced in § 1514A.

The Court of Appeals did not even *reach* those substantive protected-activity issues.[12] *A fortiori*, it could not have erroneously decided them.

Second, the principle of administrative law on which the Court of Appeals' decision hinged—i.e., that a reviewing court will not consider issues that have not been first presented to the agency under review—is well established in decisions of this Court. *See supra* at 15. It is not a question requiring further clarification or elaboration. And even if it were, this is not the case in which to do it, as Welch fails even to include it in his Questions Presented. *See* S. Ct. R. 14(a) ("Only the questions set out in the petition, or fairly included therein, will be considered by the Court.").

To summarize: the Court of Appeals fully—and correctly—decided this case on waiver grounds. Because Welch neither challenges this waiver holding in his Questions Presented nor provides any basis for this Court to question the soundness of the

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[12] The Court of Appeals did not find that Welch failed to engage in protected activity, it simply found that he failed to present sufficient legal argument and authority to the Department of Labor to support his protected-activity claim. (Pet. App. at 18a) ("We simply hold that Welch failed to raise any relevant arguments before the ARB"). Thus it did not rule one way or another on Welch's first question presented. (Pet. at i).

Nor did the Court rule on the second question presented. Contrary to Welch's argument, it did *not* hold that complaints about violations of Sarbanes-Oxley could not support a whistleblower claim under Section 1514A. Welch has not identified—and cannot identify—anywhere in the Court of Appeals' opinion that addresses that particular legal question.

Court of Appeals' waiver analysis, this Court should deny certiorari.

II. THERE IS NO CONFLICT IN THE CIRCUITS ON THE PROPER STANDARD FOR EVALUATING PROTECTED ACTIVITY IN WHISTLEBLOWER CASES BROUGHT UNDER 18 U.S.C. § 1514A.

A. The three courts of appeals that have addressed the issue apply a uniform standard for protected activity.

Even if the Court of Appeals did reach the merits of Welch's protected-activity arguments—and it did *not*—there still is no basis for certiorari because the decision below is not "in conflict with the decision of another United States court of appeals on the same important matter." S. Ct. R. 10(a).

To date, only three Circuits, the First Circuit, the Fourth Circuit, and the Fifth Circuit, have addressed what a Sarbanes Oxley whistleblower claimant must show in order to establish protected activity under 18 U.S.C. § 1514A. *See Allen v. Admin. Review Bd.*, 514 F.3d 468 (5th Cir. 2008); *Livingston v. Wyeth*, 520 F.3d 344 (4th Cir. 2008); *Day v. Staples*, No. 08-1689, 2009 U.S. App. LEXIS 2266 (1st Cir. Feb. 9, 2009). All three circuits employ an "objective-reasonableness" standard, requiring whistleblower complainants to establish both a subjective belief *and* an objectively reasonable belief that the conduct they reported constituted a violation of one of the laws enumerated in Section 1514A. *Allen*, 514 F.3d at 477; *Livingston*, 520 F.3d at 352; *Day*, 2009 U.S. App. LEXIS 2266 at *27-*28 n.10.

The three circuits articulate the objective-reasonableness standard in nearly identical terms. They all take into account the employee's professional background. *Allen*, 514 F.3d at 477 ("The objective reasonableness of a belief is evaluated based on the knowledge available to a reasonable person in the same factual circumstances with the same training and experience as the aggrieved employee. . . ."); *Livingston*, 520 F.3d at 352 ("Livingston must show not only that he believed that the conduct constituted a violation, but also that a reasonable person in his position would have believed that the conduct constituted a violation."); *Day*, 2009 U.S. App. LEXIS 2266 at *29 n.10 ("We consider the district court's concern about the plaintiff's particular educational background and sophistication to be relevant").

This objective-reasonableness analysis is consistent with the plain language of the statute, which allows relief only where "the employee *reasonably* believes" there was a violation of relevant law. 18 U.S.C. § 1514A(a)(1) (emphasis added). It is consistent with how the Department of Labor has interpreted the statute in its rules governing Sarbanes-Oxley whistleblower complaints. *See* 29 C.F.R. § 1980.102(b)(1) (defining protected activity to encompass only reports of actions that the "employee *reasonably believes* constitutes a violation" of the relevant laws) (emphasis added). And it is consistent with how the ARB has interpreted the statute and regulations in this case. Pet. App. at 32a-33a.

Because the courts of appeals are consistently and correctly interpreting the requirements for protected activity under Section 1514A, the Bank respectfully submits that this Court should deny certiorari.

B. Welch's statistical arguments are both inappropriate and unsound.

In his Petition, Welch fails to identify any inter-circuit conflict that would warrant certiorari. To the contrary; he laments that the courts have treated the issue "consistent[ly]." (Pet. at 22). Instead of identifying a fissure in the case law, Welch spends much of his Petition decrying that few whistleblowers have obtained final judicial relief under § 1514A. (Pet. at 22-23).

The outcomes of other cases do not, of course, shed any light on the merits of the present case. Nor do the legal analyses in those other decisions reveal whether the Court of Appeals in *this* case properly analyzed the legal issues presented to it. Cases must be decided on their own facts and on the law—not on statistics.

But this Court also should reject Welch's claim that the lower tribunals have rendered Section 1514A "a sham." (Pet. at 23). To begin, it is not true that the ARB has not ruled for any whistleblower. The ARB recently issued a final decision awarding relief to a Sarbanes-Oxley whistleblower claimant. *See Kalkunte v. DBI Financial Services, Inc.*, ARB Case Nos. 05-139 and -140 (ARB Feb. 27, 2009) (letter opinion available at http://www.oalj.dol.gov-/PUBLIC/ARB/DECISIONS/ARB_DECISIONS/SOX/-05_139.SOXP.PDF).

Even more to the point, statistics on fully litigated cases are a poor index of whether the statute is working as intended. Such statistics do not include settled cases. Nor do they include conduct that has been deterred because of the statute. With respect to cases that are actually brought, baseless cases likely

will be fought, and meritorious cases likely will be settled. So the fact that few fully litigated and appealed cases have resulted in employee victories does not show that the objectives of the statute are being frustrated.[13] And it certainly does not show that *this* case was improperly decided.

III. WELCH'S BELATED ARGUMENTS TO THIS COURT AND TO THE COURT OF APPEALS ALSO FAIL ON THE MERITS.

Because of its waiver holding, the Court of Appeals had no need to—and did not—reach the merits

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[13] The law review article that Welch cites acknowledges this point:

> [T]he settlements and withdrawals certainly impacted the types of cases left to be resolved by administrative decision makers.
>
> The extent of this impact is difficult to determine. Settlement of a case may provide some indication that the case had at least minimal merit and therefore arguably could be counted as an employee success. Indeed, *settlements may have removed the strongest employee cases from the pool of cases*, causing the employee win rate in resolved cases to appear lower than the number of "meritorious" claims actually filed.

Richard E. Moberly, *Unfulfilled Expectations: An Empirical Analysis of why Sarbanes-Oxley Whistleblowers Rarely Win*, 49 WM. & MARY L. REV. 65, 96-97 (2007) (emphasis added). The author concludes, cautiously, that "Ultimately, the data presently available regarding Sarbanes-Oxley settlements and withdrawals do not provide definitive answers regarding the objective merit of either the overall pool of cases or the cases that receive administrative decisions." *Id.* at 99.

of Welch's substantial-evidence claims. But even assuming arguendo that the Court of Appeals was wrong on its waiver conclusion, the undisputed facts of this case show that it reached the correct result.

The arguments in the Petition are easily summarized. Welch contends that he thought the misclassification of $195,000 violated GAAP. (Pet. at 20). He claims that this purported GAAP violation was ipso facto a violation of Sarbanes-Oxley. (*Id.*). And he asserts that he therefore was entitled to whistleblower protection for reporting these "violations." (*Id.*). There are fundamental legal and factual problems with this argument.

To begin, Welch provides no legal authority to support the proposition that GAAP violations are per se violations of Sarbanes-Oxley. As this Court has noted, accounting standards are notoriously protean and subject to varying interpretations. *See, e.g.*, *Thor Power Tool Co. v. Comm'r of Internal Revenue*, 439 U.S. 522, 544 (1979) ("'[G]enerally accepted accounting principles' are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions."). But Welch's interpretation of Sarbanes-Oxley elevates *every* minor accounting disagreement—regardless of materiality—into a potential basis for a Sarbanes-Oxley whistleblower complaint. That certainly was not Congress's intent in enacting Section 1514A. Indeed, to adopt Welch's interpretation would, as the ARB observed, "amount[] to wholesale re-writing of SOX's section 1514A." (Pet. App. at 38a).

The Sarbanes-Oxley provisions that Welch cites in his Petition do *not* establish that GAAP violations are violations of Sarbanes-Oxley. Indeed, the cited provisions are not even relevant to this case:

- Section 103, 15 U.S.C. § 7213, *simply* describes the duties of the Public Company Accounting Oversight Board, an entity created to oversee the auditors of public company. This statute does not impose any obligations on private parties.
- Section 108, 15 U.S.C. § 77s(b), authorizes—but does not require—the SEC to accept, as "generally accepted," accounting principles that meet certain criteria. Again, it imposes no obligations on private parties.
- Section 401, 15 U.S.C. § 78m(i), states that all financial reports that are otherwise required to comply with GAAP must "reflect all material correcting adjustments." For this to be triggered, the report must already have been required to be GAAP-compliant *and* the correction itself must be material—neither of which was established in this case.
- Section 302, 15 U.S.C. § 7241, requires corporate officers to certify the accuracy of financial reports presented in periodic statements. It does *not* mandate GAAP compliance. And none of the three "violations" identified by the ALJ and analyzed by the ARB involved a perceived violation of this provision.

Even now, Welch cannot establish the legal premise that violations of GAAP are ipso facto violations of Sarbanes-Oxley.[14]

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[14] Welch, tellingly, has never asserted that he suspected securities fraud in violation of Section 10(b) of the Securities Exchange Act of 1934 or Rule 10b-5 promulgated thereunder. Such a claim would have failed. *See Day*, 2009 U.S.

(note continued on following page . . .)

Removing that premise, however, causes Welch's entire protected-activity argument to collapse. The only alleged violations of federal securities law that Welch identifies in his Petition are violations of Sarbanes-Oxley. And the only alleged violations of Sarbanes-Oxley are violations of GAAP. But because GAAP violations are not in and of themselves violations of Sarbanes-Oxley and because Welch has provided no other legal explanation for why the alleged violations of GAAP in *this* case were violations of Sarbanes-Oxley, he cannot establish that he had a reasonable belief that the Bank violated any federal securities law. Thus, he cannot establish protected activity under Section 1514A. His whole whistleblower claim unravels.

The factual premise of Welch's protected-activity argument also suffers insurmountable problems. In his Petition, Welch repeatedly asserts that the misclassification of the $195,000 was a violation of GAAP. Indeed, as noted above, his entire argument hinges on that proposition. Yet there was no evidence of this in the record before the Department of Labor. During the evidentiary hearing, Welch simply stated that the misclassification of the $195,000 violated rules of the Federal Financial Institutions Examination Council ("FFIEC"), a body that estab-

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(. . . note continued from previous page)
App. LEXIS 2266, at *37 (noting that "merely stating in conclusory fashion that a company's books are out of compliance with GAAP would not in itself demonstrate liability under section 10(b) or Rule 10b-5" and finding that the plaintiff, who had alleged a GAAP violation, failed to establish that he had engaged in protected activity under Sarbanes-Oxley).

lishes standards for banks.[15] But the laws that Welch relies on concern *GAAP* standards, not *FFIEC* standards. Thus, the alleged FFIEC misclassification of the $195,000 could not supply the GAAP-violation predicate for Welch's whistleblower claim. Thus, the factual premise of his protected-activity argument fails.

In short, even at this late stage in the litigation Welch does not—and cannot—connect the three alleged "violations" with a statute or regulation enumerated in Section 1514A. His protected-activity argument thus fails on the merits.

CONCLUSION

In its opinion, the Court of Appeals held that Welch waived his protected-activity argument by failing to make relevant legal arguments to the ARB. The ruling was dispositive, yet Welch's Questions Presented ignore it entirely. For this reason alone, this Court should summarily deny certiorari.

But as pointed about above, there are additional reasons for denying certiorari. The Court of Appeals did not err in reaching its waiver conclusion. This case does not raise points of law on which the lower

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[15] On page 37 of his brief to the Court of Appeals, Welch incorrectly states that his expert Wynne Baker, testified that "generally accepted accounting principles were violated." He cites page 62 of the Joint Appendix. But that was simply testimony by Welch that "[i]nstead of these recoveries going to the loan loss reserves, as the FFIEC, the Federal Regulations require, they did not go to that recovery account." Welch's expert Wynne Baker never claimed that that the classification violated GAAP. (C.A. App. 288-90). Indeed, he never even mentions GAAP in his expert report.

courts are divided. And Welch's protected-activity claims are both legally and factually unsupported. For all these reasons, Respondent Cardinal Bankshares Corporation respectfully requests that this Court deny certiorari.

Respectfully submitted,

/s/ Betty Southard Murphy

Betty Southard Murphy
Counsel of Record
Marc A. Antonetti
Baker & Hostetler, LLP
1050 Connecticut Ave., NW
Suite 1100
Washington, DC 20036
(202) 861-1500

Joseph M. Rainsbury
LECLAIRRYAN, PC
1800 Wachovia Tower
Drawer 1200
Roanoke, Virginia 24006
(540) 510-3055

Douglas W. Densmore
GENTRY, LOCKE, RAKES & MOORE, LLP
10 Franklin Road, SE
Post Office Box 40013
Roanoke, Virginia 24022
(540) 983-9399

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No. 08-836

In the Supreme Court of the United States

DAVID E. WELCH, PETITIONER

v.

HILDA L. SOLIS, SECRETARY OF LABOR, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENT IN OPPOSITION

EDWIN S. KNEEDLER
Acting Solicitor General
Counsel of Record
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

CAROL DEDEO
Deputy Solicitor for National Operations
STEVEN J. MANDEL
Associate Solicitor
ELLEN R. EDMOND
Counsel for Whistleblower Programs
Department of Labor
Washington, D.C. 20210

QUESTION PRESENTED

Whether petitioner failed to demonstrate that he engaged in protected activity within the meaning of Section 806(a) of the Sarbanes-Oxley Act of 2002, 18 U.S.C. 1514A(a)(1).

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BRIEF FOR THE FEDERAL RESPONDENT IN OPPOSITION

OPINIONS BELOW

The judgment of the court of appeals (Pet. App. 1a-21a) is reported at 536 F.3d 269. The decision and order of the Administrative Review Board (Pet. App. 22a-46a), and the recommended decision and order of the administrative law judge (Pet. App. 47a-203a), are unreported.

JURISDICTION

The judgment of the court of appeals was entered on August 5, 2008. A petition for rehearing was denied on October 3, 2008 (Pet. App. 204a-205a). The petition for a writ of certiorari was filed on January 2, 2009 (Friday following a holiday). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Section 806(a) of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), 18 U.S.C. 1514A(a)(1), prohibits a covered entity from retaliating against an employee for providing information to a federal agency, Congress, or his employer, that he reasonably believes is related to a violation of 18 U.S.C. 1341 (mail fraud), 1343 (fraud by wire, radio, or television), 1344 (bank fraud), or 1348 (securities fraud), any rule or regulation of the Securities and Exchange Commission (SEC), or any provision of federal law relating to fraud against shareholders. The Secretary of Labor is responsible for investigating retaliation complaints under Section 806(a). After completion of an investigation, the Secretary either dismisses the complaint because it lacks merit or finds retaliation and orders appropriate relief. 18 U.S.C. 1514A(b)(2)(A).

Under statutory standards governing retaliation claims that were made applicable to Sarbanes-Oxley, the Secretary may find retaliation "only if the complainant demonstrates that [protected activity] * * * was a contributing factor in the unfavorable personnel action alleged in the complaint." 49 U.S.C. 42121(b)(2)(B)(iii). Even if the complainant makes that required showing, the Secretary may not order relief "if the employer demonstrates by clear and convincing evidence that the employer would have taken the same unfavorable personnel action in the absence of [protected activity]." 49 U.S.C. 42121(b)(2)(B)(iv).

The Secretary's regulations provide that either the complainant or the respondent may seek a de novo hearing before an administrative law judge (ALJ) to review the Secretary's decision. The ALJ's decision is subject to discretionary review by the Department of Labor's

Administrative Review Board (Board). 29 C.F.R. 1980.106, 1980.110. The Board's final decision is reviewable in the court of appeals for the circuit in which the violation allegedly occurred or in which the complainant resided on the date of the alleged violation. 49 U.S.C. 42121(b)(4)(A); 29 C.F.R. 1980.112(a). The court of appeals must uphold the agency's factual findings when supported by substantial evidence and the court reviews questions of law de novo. *Platone* v. *United States Dep't of Labor*, 548 F.3d 322, 326 (4th Cir. 2008); *Allen* v. *Administrative Review Bd.*, 514 F.3d 468, 476 (5th Cir. 2008).

2. Respondent Cardinal Bankshares Corporation is a bank holding company and sole owner of the Bank of Floyd. Ronald Leon Moore is the Chief Executive Officer of both entities (hereafter collectively referred to as Cardinal), which share a Board of Directors and managing officers. Petitioner, a certified public accountant in Virginia, began working for Cardinal in 1999 as a part-time accounting officer. Pet. App. 3a. In 2000, Moore hired petitioner as Cardinal's Chief Financial Officer (CFO). *Id.* at 3a-4a. As CFO, petitioner prepared and reviewed entries on Cardinal's general ledger accounts, devised and implemented accounting procedures, and prepared various reports and financial statements including quarterly (Form 10-QSB) and annual (Form 10-K) reports that Cardinal is required to submit to the SEC. *Id.* at 4a.

While employed at Cardinal, petitioner became concerned that the company's accounting practices were deficient in several respects. Pet. App. 4a. According to petitioner, although generally accepted accounting practices (GAAP) require that only persons who have accounting expertise be permitted to make ledger entries,

Moore would make entries himself or direct others with no special accounting expertise to make entries. *Ibid.* Petitioner was particularly concerned that in the third quarter of 2001, Moore recorded in Cardinal's ledgers two recoveries of written-off loans, totaling $195,000, as income rather than listing the amounts on the company's loan reserve account as required by GAAP. Petitioner believed that by misclassifying those loan recoveries, Cardinal overstated its year-to-date income in its 2001 third-quarter 10-QSB report. *Ibid.* During the year-end audit Cardinal's independent auditor, Larrowe & Company, PLC (Larrowe & Co.) changed the entries to conform to petitioner's recommendations, but Cardinal did not correct its 2001 third-quarter 10-QSB report to the SEC. *Id.* at 4a-5a. Petitioner also was concerned that he was being excluded from communications between Moore and Larrowe & Co. on financial issues. *Id.* at 5a. Petitioner believed that such restricted access to Larrowe & Co. prevented him from performing his tasks as CFO and from confirming the accuracy of Cardinal's financial reports. *Ibid.*

Petitioner communicated his concerns to Cardinal on several occasions, both orally and in memoranda to Moore and others. Pet. App. 5a. On August 2, 2002, petitioner informed Larrowe & Co. that he would not sign a representation letter to the auditor from Cardinal confirming the accuracy of the company's financial position because Moore and others had made ledger entries without his review and because he had been excluded from communications between Moore and the auditors on financial issues. *Ibid.* On August 14, 2002, petitioner refused to certify the accuracy of Cardinal's 2002 second-quarter 10-QSB report to the SEC, a requirement under the newly-enacted Sarbanes-Oxley Act, be-

cause of his concerns about the ledger entries, including the misclassification of loan recoveries as income. *Id.* at 5a-6a. Moore ultimately certified the reports himself. *Id.* at 6a. On September 13, 2002, petitioner sent Moore another memorandum insisting that Cardinal needed to change its accounting practices before petitioner could certify the pending 2002 third-quarter 10-QSB report. *Ibid.*

On September 17, 2002, Moore called a meeting of Cardinal's Board of Directors to discuss his dissatisfaction with petitioner. Pet. App. 6a. Moore informed the Board of Directors about the content of petitioner's memoranda and reported that in August 2002, state examiners had found numerous errors in a quarterly call report that petitioner had prepared and submitted to the Federal Reserve and the Virginia State Corporation Commission. *Id.* at 6a-7a. The Board of Directors asked its Audit Committee's legal counsel, Douglas Densmore, and Michael Larrowe of Larrowe & Co., to conduct an investigation and prepare a report on petitioner's allegations. *Id.* at 7a.

On September 20, 2002, petitioner held a briefing on Sarbanes-Oxley for senior personnel of Cardinal, at which he alleged that Cardinal's accounting practices violated Sarbanes-Oxley and that three Cardinal employees were "parties to fraudulent acts." Pet. App. 7a. Petitioner also proposed leaving Cardinal quietly in exchange for a generous severance package. *Ibid.* Following the meeting, Densmore and Larrowe attempted to meet with petitioner to discuss his allegations, but petitioner refused to meet without his personal attorney being present. *Ibid.*

On September 25, 2002, Cardinal's Board of Directors voted to suspend petitioner without pay pending the

results of Densmore and Larrowe's investigation. Pet. App. 7a. The Board of Directors ordered petitioner to meet with Densmore and Larrowe without his attorney, but petitioner again refused. *Id.* at 7a-8a.

On October 1, 2002, Densmore and Larrowe informed the Board of Directors that, based on their investigation, petitioner's allegations regarding Cardinal's accounting practices lacked merit. Pet. App. 8a. They also informed the Board of Directors that petitioner had breached his fiduciary duty to Cardinal by refusing to meet with them to discuss his allegations without his personal attorney. *Ibid.* The Board of Directors voted unanimously to accept Densmore and Larrowe's recommendation that Cardinal discharge petitioner. *Ibid.*

Following his discharge, petitioner filed a complaint under Section 806(a) of Sarbanes-Oxley with the Department of Labor, alleging that Cardinal had retaliated against him because of his complaints to Moore and others about Cardinal's accounting practices. After an investigation, petitioner's complaint was dismissed, and he requested a hearing before an ALJ. Pet. App. 9a; 29 C.F.R. 1980.106.

3. The ALJ concluded that petitioner had demonstrated by a preponderance of the evidence that Cardinal terminated his employment in violation of Section 806(a) of Sarbanes-Oxley. Pet. App. 47a-203a. The ALJ determined that three of petitioner's complaints were protected under Section 806(a): (1) that two loan recoveries were improperly recorded as income in Cardinal's ledger entries; (2) that his access to Larrowe & Co. was restricted: and (3) that Cardinal had inadequate internal accounting controls because individuals lacking necessary auditing expertise made ledger entries without his knowledge or review. Pet. App. 141a-156a. The ALJ

further determined that the proximity in time between petitioner's protected activity and his termination created an inference of retaliation and established a causal connection between his protected activity and subsequent adverse actions. *Id.* at 157a-164a. The ALJ also determined that Cardinal had failed to establish by clear and convincing evidence that it would have taken the same action in the absence of retaliation. *Id.* at 164a-172a.

4. The Administrative Review Board reversed. Pet. App. 22a-46a. The Board concluded as a matter of law that petitioner failed to demonstrate that he had engaged in protected activity within the meaning of Section 806(a) of Sarbanes-Oxley. *Id.* at 33a-46a. First, the Board held that petitioner's complaints regarding the two loan recovery entries did not allege conduct that he reasonably could believe constituted a violation of the federal securities laws. *Id.* at 36a-37a. The Board stated that because Cardinal had recovered $195,000, "an experienced CPA/CFO like [petitioner] could not have reasonably believed that the third quarter SEC report presented potential investors with a misleading picture of Cardinal's financial condition." *Id.* at 37a. Second, the Board concluded that petitioner failed to provide legal authority to support his argument that the failure of Cardinal's financial records to comply with GAAP or other federal auditing standards constituted a violation of any law listed in Sarbanes-Oxley. *Id.* at 38a. Similarly, with regard to petitioner's complaints concerning his restricted access to Larrowe & Co. and Cardinal's inadequate internal accounting controls, the Board held that petitioner did not present any legal authority to explain how his concerns related to any violations of the federal securities laws. *Id.* at 40a-42a.

5. The court of appeals affirmed. Pet. App. 1a-21a. The court first held that the Board erred in concluding that misclassifying items in a financial statement could never mislead potential investors about a company's financial condition if the misclassification does not affect the "bottom line." *Id.* at 15a. The court, nevertheless, held that the Board appropriately dismissed petitioner's complaint based on the court's determination that petitioner "utterly failed to explain how Cardinal's alleged conduct could reasonably be regarded as violating any of the laws listed in § 1514A." *Id.* at 17a. The court of appeals accordingly held that the Board properly ruled that petitioner had failed to establish that his complaints constituted protected activity. *Ibid.*

ARGUMENT

The court of appeals' decision is correct and does not conflict with any decision of this Court or any other court of appeals. Further review therefore is not warranted.

1. Sarbanes-Oxley was enacted on July 30, 2002, to restore investor confidence in the nation's financial markets after the financial scandals of such corporations as Enron and WorldCom. To further the purposes of promoting corporate responsibility and public disclosure and improving the quality and transparency of financial reporting and auditing, Sarbanes-Oxley provides whistleblower protections to employees of publicly traded companies who report corporate fraud. *Procedures for the Handling of Discrimination Complaints Under Section 806 of the Corporate and Criminal Fraud Accountability Act of 2002, Title VIII of the Sarbanes-Oxley Act*, 69 Fed. Reg. 52,104 (2004); *Carnero* v. *Boston Scientific Corp.*, 433 F.3d 1, 9 (1st Cir.), cert. denied,

548 U.S. 906 (2006). Under Section 806(a), publicly traded companies are prohibited from retaliating against an employee who provides information "regarding any conduct which the employee reasonably believes constitutes a violation of section 1341 [mail fraud], 1343 [fraud by wire, radio, or television], 1344 [bank fraud], or 1348 [securities fraud], any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders." 18 U.S.C. 1514A(a)(1).

To prevail on a retaliation complaint under Section 806(a), a complainant must prove by a preponderance of the evidence that (1) he engaged in protected activity; (2) the employer was aware of the protected activity; (3) he suffered an adverse employment action; and (4) the protected activity was a contributing factor in the unfavorable action. 18 U.S.C. 1514A(b)(2)(C); 49 U.S.C. 42121(b)(2)(B)(iii)-(iv); *Allen* v. *Administrative Review Bd.*, 514 F.3d 468, 475-476 (5th Cir. 2008).

To establish that he engaged in protected activity, the employee must demonstrate that he had both a subjective and an objectively reasonable belief that the conduct of which he complained constituted a violation of one of the laws listed in Section 806. *Livingston* v. *Wyeth, Inc.*, 520 F.3d 344, 352 (4th Cir. 2008); *Allen*, 514 F.3d at 477. The employee also must demonstrate that his communications "definitively and specifically" related to one of the relevant laws. *Platone* v. *United States Dep't of Labor*, 548 F.3d 322, 326 (4th Cir. 2008); *Allen*, 514 F.3d at 476-477.

2. Petitioner argues (Pet. 16-22) that this Court's review is warranted because the court of appeals' decision conflicts with the plain language and remedial purposes of Sarbanes-Oxley and "constricts the 'protected

activity' cognizable under Section 806 to such an extent as to repeal the statute altogether." Pet. 22. Petitioner also argues (Pet. 23) that this Court should grant review to send a signal "to the corporate community about responsible, transparent financial reporting in the post-Enron era." Neither contention has merit.

a. Contrary to petitioner's suggestion, the court of appeals' narrow, fact-bound holding does not nullify the remedial purposes of Sarbanes-Oxley's whistleblower provision. The court of appeals correctly upheld the Board's conclusion that petitioner failed to demonstrate that he provided information to his employer that he reasonably believed constituted a violation of one of the enumerated laws under Section 806(a). Pet. App. 15a-18a. In so holding, the court clarified that it was not suggesting "that a whistleblower must identify specific statutory provisions or regulations when *complaining of conduct to an employer*." *Id.* at 17a-18a (emphasis added). Rather, the court agreed with the Board that petitioner had failed to articulate *to the Board* any basis for an objectively reasonable belief that the concerns that he raised to Cardinal about the company's accounting practices constituted violations of the securities laws. The court of appeals explained that petitioner, before the Board, cited "irrelevant and inapposite authority" and "made conclusory, general statements" in support of his arguments. *Id.* at 17a.

The Board rejected petitioner's suggestion that "accounting errors were ipso facto violations of the federal securities laws." Pet. App. 38a. Because not every misapplication of GAAP or another accounting standard will constitute a violation of SEC rules, it was incumbent upon petitioner to articulate to the Board that he had a reasonable belief that Cardinal's failure to comply with

a particular standard constituted a violation of one of the laws enumerated in Section 806.[1] Cf. *Day* v. *Staples, Inc.*, No. 08-1689, 2009 WL 294804, at *12 (1st Cir. Feb. 9, 2009). Because petitioner failed to explain his legal argument in that regard, the Board appropriately determined that he had not demonstrated that he had engaged in protected activity. See *Viking Supply* v. *National Cart Co.*, 310 F.3d 1092, 1099 (8th Cir. 2002) ("[I]t is not this court's job to research the law to support an appellant's argument.") (citations omitted); *APS Sports Collectibles, Inc.* v. *Sports Time, Inc.*, 299 F.3d 624, 631 (7th Cir. 2002) ("[I]t is not this court's responsibility to research and construct the parties' arguments.") (citations omitted); see also *Hall* v. *United States Dep't of Labor*, 476 F.3d 847, 861 n.8 (10th Cir.) ("The [Board] cannot be charged with reviewing the entire record to glean and *sua sponte* raise legal theories referenced only obliquely by a party but not clearly articulated in its briefs or ruled on by the ALJ."), cert. denied, 128 S. Ct. 489 (2007).[2] Moreover, as the court of appeals recog-

[1] Petitioner argued before the Board that when Cardinal misclassified its loan recoveries as income rather than crediting the loan reserve account, it failed to adhere to GAAP, generally accepted auditing standards (GAAS), and accounting rules established by the Financial Institutions Examination Council (FIEC) for banks. See 12 U.S.C. 3301 *et seq.* Pet. App. 37a-38a. Petitioner, however, never articulated how, under the circumstances of this case, he had a reasonable belief that Cardinal's failure to comply with GAAP, GAAS, or FIEC constituted a violation of the federal securities laws. *Ibid.*

[2] The court of appeals rejected an alternative conclusion of the Board that petitioner could not have had an objectively reasonable belief that reporting the $195,000 in recovered loans as income violated one of the laws enumerated in Section 806. Pet. App. 14a-15a. With regard to the loan recoveries, the Board had suggested that a misclassification on a financial statement cannot present potential investors with a misleading

nized (Pet. App. 17a), to the extent that petitioner explained his position and cited relevant authority for the first time in his filings before the court, he forfeited the arguments by failing to raise them to the Board. *Taylor* v. *United States Dep't of Labor*, 440 F.3d 1, 8-9 (1st Cir. 2005).[3]

b. Petitioner does not argue that the unanimous court of appeals' decision conflicts with the decision of any other court of appeals or any decision of this Court. Petitioner nonetheless contends (Pet. 23) that this Court's review is warranted because the decision below "weakens" whistleblower protections under Sarbanes-Oxley and sends a "troublesome" signal to the corporate community concerning its responsibilities for transparent financial reporting in the post-Enron era. The

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picture of a company's financial condition as long as the company in fact recovered more money than it had previously. *Id.* at 37a. In an amicus brief to the court of appeals, the SEC expressed some concern with that suggestion. *Id.* at 15a. As the court of appeals indicated, however, the Department of Labor has conceded that "communications about misclassifications in financial statements *may*, in some circumstances, form the basis for a Sarbanes-Oxley whistleblower action." *Ibid.* Accordingly, petitioner's concerns (Pet. 22-23) that the court of appeals' decision will frustrate Congress's intent to protect whistleblowers who expose corporate fraud are unfounded.

[3] Similarly, in this Court petitioner generally argues that banks must follow GAAP and that the securities laws prevent the filing of reports that misrepresent the financial condition of the company. Pet. 10, 19. But the Board concluded in this case that there was no reasonable basis to conclude that Cardinal's failure to follow GAAP in the third-quarter report rendered the report misleading, because "Cardinal had in fact recovered $195,000 that it previously did not have." Pet. App. 37a. Petitioner does cite to an SEC rule that presumes that filed financial statements not prepared in compliance with GAAP are presumed to be misleading, 17 C.F.R. 210.4-01(a)(1), but petitioner failed to cite that rule before the Board.

court's decision, however, simply affirms the unremarkable principle that in proving a retaliation case, a complainant must adequately explain to the tribunal before which his case is being heard the legal basis for his claim that he engaged in protected activity. The court's decision does not merit this Court's review.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

EDWIN S. KNEEDLER
Acting Solicitor General

CAROL DEDEO
Deputy Solicitor for National Operations

STEVEN J. MANDEL
Associate Solicitor

ELLEN R. EDMOND
Counsel for Whistleblower Programs
Department of Labor

MARCH 2009

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IN THE

Supreme Court of the United States

DAVID E. WELCH, CPA, PETITIONER

v.

ELAINE L. CHAO, SECRETARY OF LABOR, UNITED STATES DEPARTMENT OF LABOR, AND CARDINAL BANKSHARES CORPORATION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY BRIEF

DONALD F. MASON, JR.
Counsel of Record

D. BRUCE SHINE

Shine & Mason
433 East Center Street
Suite 201
Kingsport, TN 37660
(423) 246-8433

CURRY & TAYLOR • (202) 393-4141

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OVERVIEW

> "And today I sign the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt. This new law sends very clear messages that all concerned must heed. This law says to every dishonest corporate leader: you will be exposed and punished; the era of low standards and false profits is over; no boardroom in America is above or beyond the law."

[U.S. President George W. Bush, signing the Sarbanes-Oxley Act July 30, 2002]

The Department of Labor terms Petitioner's claim under SOX "unremarkable," while Cardinal suggests Petitioner is "foreclosed" since he "does not even mention, let alone challenge, the Court of Appeals dispositive ruling on the waiver issue."

Focus on the discrete issues raised by Petitioner, in a vacuum, clouds the fuller picture David Welch painted with his protected communications. Petitioner, with the enactment of SOX, faced unchartered territory. He would be held personally responsible, civilly and criminally, should he erroneously certify the bank's public financial report 1) ". . . fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and (2) the information . . . fairly presents, in all material respects, the financial condition and results of operations."

Welch emphatically stated he could not so certify because:

- He had been isolated from the bank's Audit Committee as well as its outside auditor [JA 275, 276, 277];

- There were unresolved issues regarding the fair presentation and accuracy of "material (financial) items;" [JA 283, 276, 277];

- He could not vouch for the bank's "establishment" and "effectiveness" of financial disclosure controls (internal controls) and procedures; and

- CEO Leon Moore was "managing income" by directing journal entries through unauthorized personnel.

ARGUMENT AND AUTHORITIES

A. Welch's Communications "Definitively and Specifically" Related to SOX §1514A, and Went Far Beyond GAAS and GAAP

The Fourth Circuit confirmed the ARB's second rationale for dismissal of the Welch complaint, stating Welch failed to explain "how he could have an objectively reasonable belief that these (the bank's) actions violated any of the laws listed in §1514A." [*Welch v. Chao*, No. 07-1684 at 13]

The bank argued the "ALJ erred in finding protected activity because Welch's complaints . . . did not allege conduct that constituted a violation of. . . federal securities laws." [Id.] The Fourth Circuit concluded Welch "utterly failed to explain how Cardinal's alleged conduct could reasonably be regarded as violating any of the laws listed in §1514A" of SOX.

Relevant sections of SOX include:

• **Section 302** requires the CEO and CFO to certify, on each annual or quarterly financial report submitted pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, the following:

1) They have reviewed the report;

2) The report does not contain any untrue statement of material fact or omit a material fact necessary to make the statement made not misleading;

3) Based on their knowledge, the financial statements fairly present in all material respects the financial condition and results of operations of the issuer for the periods presented;

4) The CEO and CFO are responsible for establishing and maintaining internal controls; that they have designed such to insure material information is made known to such officers by others; that they have evaluated the effectiveness of

the internal controls within 90 days of their certification; that they have presented their conclusions about the effectiveness of the internal controls in their report; that they have disclosed to the issuer's auditors and audit committee all significant deficiencies in design/operation of the internal controls and have identified material weaknesses of the internal controls; the CEO and CFO must identify any fraud, whether or not material, involving management or other employees having a significant role in the issuer's internal controls; and

5) Whether there have been significant changes in the internal controls or other factors that could affect internal controls subsequent to their evaluation, including corrective actions with regard to significant deficiencies and material weaknesses.

• **Section 404** requires management assessment of internal controls through each annual SEC report required by Section 13 of the Securities Exchange Act of 1934 (15 U.S.C. 78m). The report shall (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; (2) contain an assessment of the effectiveness of the internal control structure and procedures for financial reporting.

• **Section 806** provides whistleblower protection for employees from being, among other

things, discharged for providing information regarding conduct the employee reasonably believes constitutes a violation of . . . any rule or regulation of the Securities and Exchange Commission to a person with supervisory authority over the employee.

• **Section 906** This section requires a written statement by the CEO and CFO that the financial statements fully comply with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m) or 78o(d), and that the information "fairly presents, in all material respects, the financial condition and results of the issuer." It also provides fines and penalties against the CFO of an issuer for false SOX certification up to and including $5,000,000 or 20 years imprisonment, or both.

These precise issues were advanced by Welch before OSHA, the ALJ, the ARB and the Fourth Circuit.

Welch filed his SOX complaint with OSHA December 12, 2002. He alleged SOX required him, as CFO of Cardinal, to certify "the accuracy of reporting forms filed with the Securities and Exchange Commission, in particular Form 10-QSB." [JA 16] Welch refused to certify the bank's 10-QSB and refused to sign the SOX certificate due to material, financial inaccuracies [JA 283].

Welch indicated, by memorandum to the bank's CEO, R. Leon Moore, that he (Welch) could not state, pursuant to the SOX certificate, the bank's financial report "did not contain any untrue statement of a material fact or omit to state a material fact necessary

to make the statement made . . . not misleading with respect to the period covered by the quarterly report." [JA 17]

The OSHA complaint alleged Welch could not certify the "financial statements, and other financial information included in the Quarterly Report on Form 10-QSB fairly presented in all material respects the financial condition, results of operations and cash flows . . . for the periods presented in the quarterly report." [JA 18] Neither could Welch certify the SOX mandated 10-QSB complied with SOX requirements concerning "internal financial controls and procedures (as defined in Exchange Act rules 13a-14 and 15d-14)." [Id.]

On August 14, 2002, Welch sent a memorandum to the bank's CEO, Leon Moore. [JA 275] Welch raised material, financial issues concerning the quarter ended June 30, 2002, after enactment of SOX.

> I am unable to reconcile their (the outside auditor's) numbers to ours. There are no explanatory notes that might help explain the differences. More importantly . . . I cannot give any assurances that our financials are fairly presented. For example, last year, you approved journal entries for the $45,000 and $150,000 recoveries of written off loans to be entered as other income and other real estate income. In spite of my repeated attempts to get you to correct the entries, you stood firm against any changes . . .Just last month, while performing a routine review of some of the entries you had authorized at 2001 year end charging $4,500.00 in expenses against 2001 income. Then, in May, you

> authorized the reversal of those entries. The result of these two sets of entries was a decrease in taxable income in 2001, a decrease in expenses in 2002 and an increase in net income for 2002 . . . **[T]his type of accounting does not meet GAAP ("Generally Accepted Accounting Principles). It also hints of "managing" net income which has always been unethical and now is seriously illegal.**
>
> **Not only can I not certify the accuracy of Cardinal's financial statements as required by our most recent legislation (SOX), I cannot offer assurances as to their fair presentation as presented in the 10-QSB you asked me to review.** Since Larrowe & Company lists you as the Principal Financial Officer of Cardinal . . . you may certify the accuracy of the financial statements as presented, but I cannot." [JA 275]

On September 13, 2002, Welch issued a second memorandum to Moore regarding the SOX certificate. [JA 276] Attached to this memorandum Welch affixed the very certification required by SOX Section 302, and noted:

> I have attached a Section 302 certification that contains the verbage required by the Sarbanes-Oxley Act of 2002 along with explanatory notes. The Section 302 certification is required each quarter beginning with the September 30, 2002 10-QSB . . . **I will not be able to certify the 3rd quarter's 10-QSB. The certification submitted with your 'signature' last quarter**

> **will not suffice this quarter for two reasons. First, the Section 302 certification noted above must now be submitted. Second, there are material items in the 2001 3rd quarter figures and 2001 3rd quarter year to date figures that should be restated. The restatement should be done . . . to avoid the unfair presentation of financial statements which could lead a reasonable investor to make a decision they might otherwise not make."** [Id.]

The September 2002 memo detailed why Welch could not SOX certify the 10-QSB. He noted the "3rd quarter 2001 income should be restated to properly account for $195,000 (in loan) recoveries," otherwise he could not certify the quarterly report would **"fairly present in all material respects the financial condition"** of the bank and **"would not be misleading."** [JA 277, 278, 280]

In the September 13, 2002 memorandum [JA 276] Welch noted he could not certify "all significant deficiencies in the design or operation of **internal (financial) controls** which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls," since Leon Moore, CEO of the bank, "was the only person who reports to the board;" because Welch "had been instructed" by Moore "not to address the audit committee;" and because Moore "had been the (practically) exclusive contact with (outside auditors) Larrowe & Company."

At JA 283, Welch noted the **stringent criminal penalties** which attach to a "knowing . . . statement which does not comport" with SOX, including a fine of "not more than $5,000,000 or imprisoned not more than 20 years, or both." [Id.]

Contrary to the Fourth Circuit's assertions, Welch very specifically, by memoranda and multiple exhibits with detailed notes, explained his precise "theory of the case."

B. Welch's Complaints to Cardinal were Self Enunciating – His Refusal to Certify the Bank's Financials Pursuant to SOX Constitutes Protected Activity

Welch's claims had their genesis in SOX. [RDO, JA 345] Welch repeatedly told Moore "that too many people were making journal entries without (his/Welch/the CFO's) approval," citing as an example the two entries "totaling $195,000" in his August and September 2002 memoranda and attachments. [JA 275; JA 276-284; JA 355]

The ALJ noted, referring to paragraph two of JA 277, that the SOX certificate stated "this quarterly report does not contain any untrue statement of a material fact" and "is not misleading with respect to the period covered by the report (10-QSB)" [JA 358] Welch specifically noted "income should be restated to properly account for the $195,000 recoveries." [JA 277, 283, 355]

The ALJ noted 3rd quarter "income and balance sheets (for 2001) would appear in the following year in the third quarter of 2002 as **comparative statements relied upon by investors.**" [JA 357] Welch testified Moore's "**practices of making credit entries to Sundrey Credits and debit entries to Sundrey Expenses at year end . . . are misleading to the financial statement reader.**" [JA 359]

At JA 400, the ALJ holds: "The third-quarter (SOX) certification required Welch to insure that Cardinal's quarterly report contained no "untrue statement of a material fact" and "fairly presented in all material respects the bank's financial conditions. Welch could have reasonably believed he could not make the necessary certification because the entries in question resulted in material misstatement of Cardinal's status." [JA 400]

Welch repeatedly reported to Respondent his concern that Cardinal's internal controls were deficient because "[a]ll too often, journal entries (that should have prior review) are made by persons outside the finance Department without the CFO's review or knowledge" (CX 17). As examples, Welch cited the two improper entries totaling $195,000 as well as entries to sundry accounts (CX 20, CX 23 at 2-3, 5-7). In particular, he indicated that the entries for $195,000"were made by someone not having the appropriate knowledge relating to generally accepted accounting principles, FFIEC guidelines or IRS regulations" (CX 23 at 3). Furthermore, in his September 13th memorandum to Moore, Welch also asserted that he was not given a chance to review such journal entries, as required by his job description (CX

23 at 5-7; Tr. 61).

The ALJ specifically relied upon the SOX 10-QSB and the SOX certificate, both of which became law and were required filings with the passage of SOX on July 30, 2002. The Fourth Circuit's insistence Welch "utterly failed to explain how Cardinal's alleged conduct could reasonably be regarded as violating any of the laws listed in §1514A" of SOX **overlooks the specific requirements of SOX** laid out by Welch in his memoranda and exhibits. Welch could not certify the bank's financial statements as satisfying the precise language of the SOX certificate. **The Fourth Circuit's "other worldly" view of §1514A excludes compliance with the SOX certificate as one of the "laws listed in §1514A." Problems with the bank's SOX documents themselves (10-QSB and SOX certificate) were, at every level of this proceeding, advanced by Welch and were "self-enunciating."**

The Fourth Circuit cites *Hall v. U.S. Department of Labor, Administrative Review Board*, 476 F.3d 847, 861 n. 8 (10th Cir. 2007) to support the proposition that the ARB "does not have to 'sua sponte' raise legal theories referenced obliquely but not clearly articulated." Here, Welch communicated exactly why he could not certify the bank's 10-QSB or execute the SOX certificate. **He raised issues regarding the material accuracy of financial statements and internal financial controls specifically required by SOX.** [JA 14-29] The ALJ made specific findings regarding this testimony. Welch distinguished between non public filings he approved and the SOX filings, which he refused to certify. **"With respect to**

the SOX 10-QSB's, he testified, in contrast, they contained comparative financial information, they were for public consumption, the Sarbanes-Oxley Certification contained a more rigorous standard, the Act (SOX) provided for specific penalties for false certifications, and it (SOX) promised to protect his employment in the event he raised concerns about improper conduct." [JA 401; Tr. 69-72]

The very heart and soul of every complaint dealt with the certification mandate of SOX. Welch provided his thinking to the CEO of the bank through memoranda, SOX Form 10-QSB notes, and the SOX certificate, with notes. **Point by point, he explained his position relative to SOX and the public financial disclosures regarding the bank's financial condition and internal financial controls. To exclude the very requirements of SOX from §1514A's coverage "any provision of Federal law relating to fraud against shareholders ignores the requirements of SOX specifically designed to protect investors." This is error as a matter of law.**

Welch's SOX objections are interlaced throughout every shred of evidence presented. Unlike the *Hall* case cited by the Fourth Circuit, in which there was an attempt to raise a novel theory of constructive discharge, **Welch consistently alleged and introduced evidence as to why he could not SOX certify the bank's financials or sign the SOX certificate.**

The record evidence clearly establishes that Welch, before the ALJ, the ARB and the Fourth

Circuit, set out the specific rationale for his refusal to SOX certify.

C. Welch Raised All Relevant Issues Below

Welch's Reply Brief to the ARB at pages 2 and 3 adopted "the summary of the evidence of ALJ Purcell contained within the RDO (JA 344-394) on pages 2-50 as if copied verbatim herein."

At page 7 of the Reply Brief he states: "As demonstrated by CX 27, pages 6-14, Welch details with specificity certain actions by Cardinal which came within the purview of Section 806 of Sarbanes-Oxley. The most significant are accounting issues which inflated Cardinal's financial statements upon which the investing public relies to make investment decisions." [CX 27, 6-14] The ARB had before it each and every argument and exhibit advanced by Welch relative to SOX. See: Attached Addendum for CX 27, 6-11; Memorandum of August 14, 2002 (JA 225); Memorandum of September 13, 2002 (JA 276-284).

The ARB was directed to each and every SOX concern raised by Welch. These same SOX concerns were raised at every stage (OSHA; ALJ; ARB; Fourth Circuit). The Fourth Circuit's logic demonstrates a blinder vision approach to SOX. From an alternate universe perspective, the Fourth Circuit eerily gazes past Welch's specific SOX complaints to see – nothing.

The Fourth Circuit cites *Taylor v. U.S. Department of Labor*, 440 F.3d 1, 8-9, for the proposition that Welch "raised new arguments relying

on newly identified authorities," concluding "Welch has forfeited these new arguments by failing to raise them before the ARB."

The *Taylor* case dealt with a situation in which appellant, for the first time at the appellate level, raised a waiver of immunity claim "never raised before either the ALJ or the ARB." Here, Welch fully and completely articulated all factual and SOX compliance issues before OSHA, the ALJ, the ARB and the Fourth Circuit, specifically including rationale for his refusal to SOX certify the bank's SOX required financials.

CONCLUSION

Seven years after the passage of SOX the banking industry is dominated by brazen fraud. SOX must be broadly construed, and Welch's petition for review should be accepted to put an end to banking industry fraud.

Respectfully Submitted,

Donald F. Mason, Jr.
Counsel of Record
D. Bruce Shine
Shine & Mason
433 East Center Street
Suite 201
Kingsport, TN 37660
(423)246-8433

The Bank of Floyd
MEMORANDUM

To: Leon Moore
From: Dave Welch
Date: August 14,2002

Re: 10Q for the Quarter Ended June 30, 2002

After attempting to tie Larrowe & Company's figures to our FR Y9LP, FR Y9C and Cardinal's Consolidated financials for June 30th. I am unable to reconcile their's to ours. There are no explanatory notes that might help explain the differences.

More importantly, though, as I have stated to you on numerous occasions in the past, when there are so many people making journal entries without my knowledge or approval, I cannot give any assurances that our financials are fairly presented. For example, last year, you approved Journal entries for the $45,000 and $150,000 recoveries of written-off loans to be entered as other income and other real estate income. In spite of my repeated attempts to get you to correct the entries, you stood firm against any changes. It wasn't until I brought them to Beth's attention at year-end that the proper adjustments were made.

Just last month, while performing a routine review of some expense accounts, I noted some of the entries you had authorized at 2001 year-end charging $4500 and expenses against 2001 income. Then, in May, you authorized the reversal of those entries. The result of these two sets of entries was a decrease in taxable

income in 2001, a decrease in expenses in 2002 and an increase in net income for 2002. We discussed this practice the first year I came here. As I said then, this type of accounting. It also hints that at "managing" net income which has always been unethical and is now seriously a legal.

Not only can I not certify the accuracy of Cardinal's financial statements as required by our most recent legislation. I cannot offer any assurances as to their fair presentation as presented in the 10Q you asked me to review. Since Larrowe & Company lists you as the Principal Financial Officer of Cardinal Bankshares Corporation, you may certify the accuracy of the financial statements is presented, but I cannot.

The Bank of Floyd
MEMORANDUM

To: Leon Moore
From: Dave Welch
Date: September 13, 2002

Re: 10-QSB Certifications

Two weeks from Monday, the 3rd quarter will be ending. Shortly thereafter, another 10-QSB will be due. It would be my preference to avoid the friction experience last quarter. In order to avoid any misunderstandings, I have attached a section 302 certification that contains the verbage require by the Sarbanes-Oxley Act of 2002 along with explanatory notes. The Section 302 certification is required each quarter beginning with September 30, 2002 10-QSB. It is also required to be part of the 10-QSB rather than being filed as a separate document. This is to assure its availability to anyone who wishes to review Cardinal's financials.

The first copy of the 302 certification is as it should be submitted except for the signature and date. The second copy has key phrases underlined and in bold type. Each of these phrases is connected to a comment box which has a brief explanation as to why I will not be able to certify the third quarter's 10-QSB.

The certification submitted with your "signature" last quarter will not suffice this quarter for two reasons. First, the section 302 certification as noted above must now be submitted. Second, there are material items in the 2001 3rd quarter figures and 2001 3rd quarter YTD

figures that should be restated. The restatement should be done in order to avoid the unfair presentation of financial statements which could lead a reasonable investor to make a decision they might otherwise not make.

I would like to address these issues with you today so you can have something to think about over the weekend. We need to read some resolution.

Form 10-QSB

CERTIFICATIONS

I, David E. Welch, certified that:

1. I have reviewed the quarterly report on Form 10-QSB of Cardinal Bankshares Corporation

2. Based on my knowledge, this **quarterly report does not contain any untrue statement of a material fact** or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, **not misleading with respect to the period covered by this quarterly report**:

3rd Qtr 2001 income should be restated to properly account for the $195.000 recoveries

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, **fairly present in all material respects the financial condition, results of operations** and cash flows of the registrant as for, and for, the periods presented in this quarterly report;

L & C communicates exclusively with CEO on all disclosure matters

4. The registrant's **other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures** (as defined in

Exchange Act Rules 13a and 15d-14) for the registrant and have;

I have not participated nor been consulted in the design of disclosure controls and procedures

(a) **design such disclosure controls and procedures** to ensure that the material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

(b) **evaluated the effectiveness of the registrant's disclosure controls and procedures** as of the date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

I have not evaluated the effectiveness of disclosure controls and procedures

(c) **presented in this quarterly report our conclusion about the effectiveness of the disclosure controls and procedures based on our evaluation** as of the Evaluation Date;

No evaluation. The CFO isn't permitted to address Audit Committee or Board

5. The registrant's other **certifying officers and I have disclosed** based on our most recent evaluation, **to the registrant's auditors and the audit committee or registrant's Board of Directors** (or persons performing the equivalent functions):

Only the deficiency of too many non-accounting people making JEs w/o Finance review or approval has been brought to the attention of CEO & External Auditors.

Dual control does not make an entry meet GAAP

(a) **all significant deficiencies in the design or operation of internal controls** which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weakness in internal controls; and

If insider trading is considered fraud, it has been reported to CEO

(b) **any fraud**, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control; and

see previous comments

6. The registrant's **other certifying officers and I have indicated** in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

David E. Welch, CPA, Chief Financial Officer

Item # /Comments or Recommendation

1. Self-explanatory. No comments necessary.

2. The following two phrases are related:

a. "... quarterly report does not contain any untrue statement of a material fact..." and

b. "... not misleading with respect to the period covered by this quarterly report;"

In June and July of 2001, we received two recoveries on loans that had been written off quite some time before. When these monies were received they should have been given to me with an explanation as to what they were for. Instead of booking them improperly as income, I would've booked both the $45,000 and the $150,000 amounts to the Valuation Reserve.

As it occurred, the entries were made by someone not having the appropriate knowledge relating to generally accepted accounting principles, FFIEC guidelines or IRS regulations. As a result, when I found the entries during my monthly G/L review, I brought them to your attention to get the entries changed.

Over the course of the last six months of 2001, I brought this issue to your attention at each of our Senior Officer meetings. Each time, you disagreed with my opinion and with the regulations or refuse to change the entries. At year end, Larrowe & Company made the changes as I had previously recommended.

As a result of these incorrect entries, Income, after

income tax a fact, was overstated by 13.7% for the third quarter of 2001 and 7.4% for the YTD September 30, 2001.

Net Loans were overstated by $195,000 (only 0.2%); Valuation Reserves were understated by $195,000 or 14.1%; Other Liabilities were overstated by $66,300 or 17.4%; and Retained Earnings were overstated by $128, 700 or 4.5%.

Therefore, the Income Statement, Balance Sheet, and Cash Flow Statement for the third quarter of 2001 should be restated to accurately reflect the results of operations, financial condition, and cash flows (see attached sample Income Statement and Balance Sheet).

RECOMMENDATIONS: (1) Abide by the policies that my job description implies are in existence and (2) lounge to follow these policies.

Examples of these policies are:

a. "compiles and analyzes financial information to prepare entries to accounts, such as general ledger accounts, documenting business transactions."

b. "Determines proper handling of financial transaction and approve transactions within designated limits."

c. "Monitors compliance with generally accepted accounting principles and company procedures."

3. the phrase "... fairly present in all material respects the financial condition, results of operations..." applies to the figures noted in item number two above. These are material amounts and could, conceivably, impact the decision-making of a potential investor relying on those numbers.

RECOMMENDATION: permit me to perform the job functions as outlined in my job description.

Examples would include:

a. the three items listed in item 2 recommendations above, and

b. "on its contracts, orders, and vouchers, and prepares reports to substantiate individual transactions prior settlement", and

c. "reviews, investigate, and corrects errors and inconsistencies in financial entries, documents, and reports."

4. the phrase "other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures..." is a significant process in which I had no input. Since your memo states that you are "well aware of the certification process and... well aware of the needs... discussed", I won't bore you with the requirements. However, I cannot swear (or certify) that I:

a. "designated such disclosure controls and procedures..." since I did not participate in their design.

b. "the body weighted effectiveness of the registrant's disclosure controls and procedures..." since they have not been presented to me for evaluation.

c. "presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation..."

I could not state what I did not do.

RECOMMENDATION: Permit me to review the disclosure controls and procedures you have put into place in order to evaluate their effectiveness.

5. I cannot swear to the statement, "The registrant's other certifying officers **and I** have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee or registrant's Board of Directors (or persons performing the equivalent functions)" as the statement relates to items (a) and (b) below:

(a) "all **significant deficiencies in the design or operation of internal controls** which could adversely a fact the registrant's ability to record, process, summarizing report financial data and have identified for the registrant's offers any material weaknesses in internal controls";

since you are the only person who reports to the board and I have been instructed by you not to address the audit committee and you have been (practically) exclusive contact with Larrowe & Company, I cannot certify any portion of this statement.

This is not a situation seen in very many banks. Most banks have at least two officers on the board for purposes of accountability as well as for providing diversification of opinion on loan generation methods, marketing approaches, accounting and other operational issues that come before the board.

On several occasions over the past 3 ½ years, I have mentioned to you and to Larrowe & Company the deficiency of too many people (who have no accounting or finance expertise) making journals entries without giving Finance an opportunity to review or approve them. This situation relates to my recommendation for items two and three above.

Of course, routine journal entries, such as the ones Pat Harris makes to allocate the cost of the deposit tickets, etc. to the branches or the income tax entries Customer Service makes pertaining to deposit interest payments would not require review.

Sometimes, we may be under the mistaken impression that two signatures validate a journal entry. That is not necessarily so. As we have observed, it sometimes just means that two people are wrong. As I have often said, "Dual control does not make an entry meet GAAP."

(b) "**any fraud**, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls";

If the asppearance of insider trading would be considered fraud, then I have reported this to you.

Another issue that I have brought your attention is the

practice of making credit entries to Sundry Credits (liability account) and debit entries to Sundry Expenses at year-and. These are misleading to the financial statement reader.

While the entries alone somewhat misleading, the entries made in the following year that reversed the Sundry Credits entries (debits) and reduce the expense accounts such as Education Expense, Transportation and Travel and Meal Expense and Officer Expense are even more misleading. As a result of this second set of entries, it appears that expenses for the second year are less than they actually were, thus, overstating net income in the second year.

While this may have been an acceptable practice many years ago, generally accepted accounting principles requires that income and expenses be matched against the period in which they are incurred.

RECOMMENDATION: Permit me to perform the job functions as outlined in my job description. Listed below are the items previously noted in items two and three above:

a. "compiles and analyzes financial information to prepare entries to accounts, such as general ledger counts, documenting business transaction";

b. "Determines proper handling of financial transaction and approves transactions within designated limits";

c. "Monitors compliance with generally accepted accounting principles and company

procedures";

d. "Audits contracts, orders, and vouchers, and prepares reports to substantiate individual transactions prior to settlement"; and

e. "Reviews, investigate, and corrects errors and inconsistencies in financial entries, documents, and reports."

6. "The registrant's other certifying officers **and I** have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies in material weaknesses."

I cannot swear to this assertion since there has not been a recent evaluation of internal controls in which I participated.

RECOMMENDATION: Permit me to review the findings on the most recent review of internal controls in order to evaluate whether any material weaknesses exist.

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350 AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Cardinal Bankshares Corporation (the "Company") on Form 10-Q for the period ending June 30, 2002, as filed with the Securities and Exchange Commission on the date here of (the "Report"), the undersigned **Chief Executive Officer AND Chief Financial Officer** of the Company hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 that, based on our knowledge and belief: (1) **the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and (2) the information contained in the Report fairly presents** in all material respects, the financial condition and results of operations of the Company as of and for the periods covered in the report

_____

Ronald Leon Moore, Chief Executive Officer

_____

David E. Welch, CPA, Chief Financial Officer

_____, 2002

Absence of both signatures results in not being in compliance.

No attempt was made by CEO to bring the financial statements into compliance.

The issues noted in a memo to the CEO were not discussed with the CFO.

Section 1350 of the Sarbanes-Oxley Act of 2002 states: "Whoever willfully certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $5,000,000, or imprisoned not more than 20 years, or both".

The attached submission fails two tests. (1) It does not contain both signatures, and (2) it was submitted knowing there were issues with fair presentation and accuracy.

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350 AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Cardinal Bankshares Corporation (the "Company") on Form 10-Q for the period ending June 30, 2002, as filed with the Securities and Exchange Commission on the date here of (the "Report"), the undersigned Chief Executive Officer and Chief Financial Officer of the Company hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 that, based on our knowledge and belief: (1) to the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and (2) the information contained in the Report fairly presents in all material respects, the financial condition and results of operations of the Company as of and for the periods covered in the report

_____

Ronald Leon Moore, Chief Executive Officer

_____

David E. Welch, CPA, Chief Financial Officer

_____, 2002

Form 10-QSB

CERTIFICATIONS

I, David E. Welch, certify that:

1. I have reviewed the court would report on Form 10-QSB of Cardinal Bankshares Corporation.

Without the external auditor's work papers, I will not be able to reconcile their numbers on the 10-USB to our general ledger numbers.

In order, the external auditor has failed to respond to my request for their work papers.

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report:

In June and July of 2001, we received two recoveries on loans that had been written off quite some time before. When these monies were received they should have been given to me with an explanation as to what they were for. Instead of booking them improperly as income, I would've booked both the $45,000 and the $150,000 amounts to the Valuation Reserve.

As it occurred, the entries were made by someone not having the appropriate knowledge relating to generally accepted accounting principles, FFIEC guidelines or IRS regulations. As a result, when I

found the entries during my monthly G/L review, I brought them to your attention to get the entries changed.

Over the course of the last six months of 2001, I brought this issue to your attention at each of our Senior Officer meetings. Each time, you disagreed with my opinion and with the regulations or refuse to change the entries. At year end, Larrowe & Company made the changes as I had previously recommended.

As a result of these incorrect entries, Income, after income tax a fact, was overstated by 13.7% for the third quarter of 2001 and 7.4% for the YTD September 30, 2001.

Net Loans were overstated by $195,000 (only 0.2%); Valuation Reserves were understated by $195,000 or 14.1%; Other Liabilities were overstated by $66,300 or 17.4%; and Retained Earnings were overstated by $128, 700 or 4.5%.

Therefore, the Income Statement, Balance Sheet, and Cash Flow Statement for the third quarter of 2001 should be restated to accurately reflect the results of operations, financial condition, and cash flows (see attached sample Income Statement and Balance Sheet).

On September 19, 2002, our CEO instructed me to restate the financials however I want to. However, I can only restate our internal documents. Our external auditors prepared the 10-QSB which must be restated for the third quarter 2001. Then, the external auditors, along with our CEO, must

decide what disclosure statements must be included. The restatements for the third quarter 2001 within ripple through the 10-KSB and the first and second quarter 2002 10-QSBs.

In addition to the 10-QSB, the third and fourth quarter 2001 Call Reports and FR Y9 (Holding Company) Reports must also be resubmitted along with the appropriate action to limit for a comments. The changes in the third and fourth quarter 2001 reports will ripple through to the first and second quarter reports as well.

CFO's RECOMMENDATIONS: (1) Abide by the policies that my job description implies are in existence and (2) lounge to follow these policies.

a. "compiles and analyzes financial information to prepare entries to accounts, such as general ledger accounts, documenting business transactions."

b. "Determines proper handling of financial transaction and approve transactions within designated limits."

c. "Monitors compliance with generally accepted accounting principles and company procedures."

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as for, and for, the periods presented in this quarterly report;

This section applies to the figures described in item 2 above. These are material amounts incurred, conceivably, impact the decision-making of a potential investor relying on those numbers.

CFO's RECOMMENDATION: Permit me to perform the job functions as outlined in my job description. For example, the CFO, in addition to the two points listed in item 2 above,

a. "Audits contracts, orders, and vouchers, and prepares reports to substantiate individual transactions prior to settlement"; and

b. "Reviews, investigate, and corrects errors and inconsistencies in financial entries, documents, and reports."

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a and 15d-14) for the registrant and have;

(a) designed such disclosure controls and procedures to ensure that the material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

(b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of the date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

(c) presented in this quarterly report our conclusion about the effectiveness of the disclosure controls and procedures based on our valuation as of the Evaluation Date;

The three steps above our parts of a significant process in which I have had no input. I cannot certify that I did beast for I did not.

<u>CFO's RECOMMENDATION</u>: Permit me to review the disclosure controls and procedures that have been put into place by the CEO in order to evaluate their effectiveness.

5. The registrant's other certifying officers and I have disclosed based on our most recent evaluation, to the registrant's auditors and the audit committee or registrant's Board of Directors (or persons performing the equivalent functions):

(a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weakness in internal controls; and

Since the CEO is the own person her reports to the board and I have been instructed by the CO not to address the audit committee and the CEO has been the (practically) exclusive contact with Larrowe & Company, I cannot certify any portion of this statement.

This is not a situation seen in very many banks.

Most banks have at least two officers on the board for purposes of accountability as well as for providing diversification of opinion on loan generation methods, marketing approaches, accounting and other operational issues that come before the board.

On several occasions over the past 3 ½ years, I have mentioned to you and to Larrowe & Company the deficiency of too many people (who have no accounting or finance expertise) making journals entries without giving Finance an opportunity to review or approve them. This situation relates to my recommendation for items two and three above.

Of course, routine journal entries, such as the ones Pat Harris makes to allocate the cost of the deposit tickets, etc. to the branches or the income tax entries Customer Service makes pertaining to deposit interest payments would not require review.

Sometimes, we may be under the mistaken impression that two signatures validate a journal entry. That is not necessarily so. As we have observed, it sometimes just means that two people are wrong. As I have often said, "Dual control does not make an entry meet GAAP."

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control; and

If the appearance of insider trading is considered fraud, it has been reported to CEO.

Another issue that I have brought your attention is the practice of making credit entries to Sundry Credits (liability account) and debit entries to Sundry Expenses at year-and. These are misleading to the financial statement reader.

While the entries alone somewhat misleading, the entries made in the following year that reversed the Sundry Credits entries (debits) and reduce the expense accounts such as Education Expense, Transportation and Travel and Meal Expense and Officer Expense are even more misleading. As a result of this second set of entries, it appears that expenses for the second year are less than they actually were, thus, overstating net income in the second year.

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e. "Reviews, investigate, and corrects errors and inconsistencies in financial entries, documents, and reports."

6. The registrant's other certifying officers and I have indicated in this courtly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

I cannot swear to this assertion since there has not been a recent evaluation of internal controls in which I participated.

CFO's RECOMMENDATION: Permit me to review the findings on the most recent review of internal controls in order to evaluate whether any material weaknesses exist.

David E. Welch, CPA, Chief Financial Officer

CARDINAL BANKSHARES CORPORATION AND SUBSIDIARIES CONDENSED CONSOLIDATED BALANCE SHEET AS OF SEPTEMBER 30

(in thousands)	Restated 2001	2001	2000
ASSETS			
Cash and due from banks	$3270	$3270	$2631
Investment securities	46867	46867	57303
Loans, net	113000	113195	92602
Premises and equipment	2356	2356	2487
Fed Funds sold	9800	9800	4475
Other Assets	2351	2351	3742
Total Assets	$177644	$177839	$163240
LIABILITIES			
Deposits	$155445	$155445	$143033
Other liabilities	711	777	529
Total liabilities	156156	156222	143562
STOCKHOLDERS' EQUITY			
Common stock*	15357	15357	5119
Surplus	2925	2925	2925
Retained Earnings	2862	2990	11765
Unrealized gains/ (losses) on securities held for sale	344	344	(131)
Total liabilities and stockholders' equity	$177644	$177838	$163240

*1,535,733 and 511,911 shares issued in 2001 and 2000 respectively.

CARDINAL BANKSHARES CORPORATION AND SUBSIDIARIES CONDENSED CONSOLIDATED STATEMENTS OF INCOME THIRD QUARTER

In thousands, except per share data	Restate 2001	2001	2000
Interest income	$3302	$3302	$2919
Interest expense	1672	1672	1499
Net interest income	1630	1630	1420
Provision for credit losses	145	145	150
Net interest income after provision for credit losses	1485	1485	1485
Other income	20	170	91
Other expense	714	714	796
Income before income taxes	791	941	565
Income tax exposure	166	217	121
Net income	$625	$724	$444
Net income per share	$0.41	$0.47	$0.30

Number of Shares 1535733 1535733 1477233
Stock Split Restated Retroactively

CARDINAL BANKSHARES CORPORATION AND SUBSIDIARIES CONDENSED CONSOLIDATED STATEMENTS OF INCOME YEAR-TO-DATE THROUGH SEPTEMBER

In thousands, except per share data	Restate 2001	2001	2000
Interest income	$9501	$9501	$8578
Interest expense	4908	4908	4404
Net interest income	4593	4593	4174
Provision for credit losses	400	400	400
Net interest income after provision for credit losses	4193	4193	3774
Other income	254	449	256
Other expense	2342	2342	2338
Income before income taxes	2105	2300	1692
Income tax exposure	480	546	359
Net income	$1625	$1754	$1333
Net income per share	$1.06	$1.14	$0.90

Number of Shares 1535733 1535733 1477233
Stock Split Restated Retroactively